POLYTECHNIC UNIVERSITY OF THE PHILIPPINES
College of Accountancy and Finance

INSTRUCTIONAL MATERIALS FOR

ACCO 20103

INTERMEDIATE ACCOUNTING 3

COMPILED BY:
Jhim Boi A. Abel
John Carlo G. Abillonar
Noel A. Bergonia
Grace A. Manalo
Nenita S. Robles
Conception M. Vedasto

COURSE OUTCOMES

Upon completion of the course, the students will be able to:

- have sound knowledge of the accounting standards applicable to the recognition, classification, measurement and derecognition of financial liabilities, non-financial liabilities, leases, and shareholders' equity.
- understand the appropriate presentation of the major liability and equity accounts and related revenues and expenses in the financial statements, including the appropriate disclosures.
- apply the accounting standards in the presentation of financial liabilities, non-financial liabilities, leases, shareholders' equity, and related revenue and expense items on the financial statements, including the required disclosures.
- apply the skills in systematic problem solving.
- present computations and financial statements in good form.
- appreciate the importance of appropriate accounting and reporting for various users of accounting information.
- realize the contributions of accounting standards to the development of a more socially responsible and morally upright professional accountant.

Module 1
FINANCIAL LIABILITIES

Overview

IAS 1 Presentation of Financial Statement defines “Liabilities”, as a present obligation of an entity arising from past transactions or events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Module Objectives

After successful completion of this module, you should be able to:

- understand the nature of financial liabilities;
- define liabilities and explain their essential characteristics (IAS 1);
- explain the nature of accounts payable, notes payable and bonds payable;
- describe the initial recognition of financial liabilities based on IFRS 9;
- describe the transactions subsequent to initial recognition of accounts payable, notes payable and bonds payable;
- identify the process of settlement of financial liabilities; and
- present financial liabilities and relevant information in the financial statements.

Course Materials:

Essential Characteristics of a Liabilities

1. *Present obligation* – it may be legal obligation or constructive obligation
    - Legal obligation – this is the one that derive from a contract, legislation, or other operation of law. An obligation may be legally enforceable as a consequence of binding contract or statutory requirement.
      Example is with the accounts payable for goods and services received.
    - Constructive obligation – give rise to liabilities by reason of normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.
      Example, an entity decides as a matter of policy to rectify faults in the products even when these become apparent after the warranty period has expired.
2. *Arises from past event* – means that liability is recognized when incurred. The past event that leads to a legal or constructive obligation is known as the obligating event.
   Example, the acquisition of goods gives rise to accounts payable. The obligating event is the acquisition of goods.
3. Outflow of future economic benefits – means that the liability must be to *pay cash*, *transfer noncash asset* or *provide service* at some future time.

FINANCIAL LIABILITIES

Under IFRS, a financial liability can be either of the following items:

- A contractual obligation to pay cash to another entity or a potentially unfavorable exchange of financial assets or financial liabilities with another entity.
- A contract probably to be settled in the entity’s own equity and that is a non-derivative under which the entity may deliver a variable amount of its own equity instruments, or a derivative that probably will be settled other than through the exchange of cash or similar for a fixed amount of the entity’s equity.

However, rights, options and warrants issued by an entity on a pro-rata basis to existing shareholders to issue own shares of capital are not financial liabilities but are equity.

INITIAL RECOGNITION OF FINANCIAL LIABILITIES

Financial liabilities shall recognize in accounting when, and only when, an entity assumes an obligation to deliver cash or another financial asset.

At initial recognition, an entity measures a financial liability at its fair value plus or minus, in the case of a financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial liability.

For financial liabilities that will be subsequently measured at amortized costs, initial measurement will be the transaction price minus the cost incurred to received whatever is considered as a result of incurring the liability.

ACCOUNTS PAYABLE

Accounts payable are trade liabilities arising from the purchase of goods or services that are consumed or to be sold by the entity in the normal conduct of business.

Accounts payable is considered to be current when it is expected to be realized within one year or in a normal operating cycle whichever is longer. And if there is no transaction cost, accounts payable must be initially measured at the transaction price.

The liability for goods purchased must be recorded when the entity acquires from the seller the significant risks and rewards of ownership of goods. In most cases, this coincides with the transfer of the legal title or the acquisition of ownership. The transfer of title depends on the terms of purchase (which could either be FOB shipping point or FOB destination). A purchase made towards the end of the accounting period, where goods are still in transit, should be recognized as a liability when the term of shipment is FOB shipping point. The cost of the goods, likewise, is included in the ending inventory. The record of goods received (inclusion in ending inventory) should be in agreement with the liability (recognition of accounts payable). Both the liability and the inventory should be reflected in the financial statements of the proper reporting period.

Illustration:

The balance in Copper Company's accounts payable account at December 31, 2020 was 1,550,000 before any year-end adjustments relating to the following:

- Goods were in transit from a vendor to Copper on December 31, 2020. The invoice cost was P70,000 and the goods were shipped FOB shipping point on December 28, 2020. The goods were received on January 5, 2021.
- Goods shipped FOB shipping point on December 15, 2020 from a vendor to Copper, were lost in transit. The invoice cost was P43,500. On January 3, 2021, Copper filed a P43,500 claims against the common carrier.
- Goods shipped FOB destination on December 24, 2020, from a vendor to Copper, were received on January 7, 2021. The invoice cost was P16,500.

What amount should Copper report as accounts payable on its December 31, 2020 statement of financial position?

Solution:

Accounts Payable – Unadjusted balance	1,550,000
Goods in transit	70,000
Goods lost in transit (FOB Shipping Point)	43,500
Accounts Payable – Adjusted balance	**1,663,500**

- *For goods shipped FOB shipping point – title to the goods passes from seller to the buyer at the point of shipment or point of delivery while goods shipped FOB destination – title to the goods passes to the buyer upon receipt of the goods.*

- *The goods shipped FOB shipping point on December 15, 2020 but lost in transit does not take the liability of Copper Company to the seller.*

Methods of Accounting for Accounts Payable:

A. *Gross Method*
    - Accounts payable is recorded without deducting cash discount offered.
    - Cash discount is recorded as deduction from cost/expense when taken.
    - Yearend adjustment is made for accounts settled in subsequent period within the discount period

B. *Net Method*
    - Accounts payable is recorded net of cash discount
    - Cash discount is recorded as "*Purchase Discount Lost*" and reported as a Finance cost, when it is not taken
    - Yearend adjustment is made for accounts whose discount period already lapsed

Illustration:

Assume GCQ Company purchased from MECQ Company with an invoice price of P100,000; term FOB Shipping point, 2/10; n/30. GCQ Company uses periodic inventory system. Entries in the books of GCQ Company to record the purchase and payment under the gross and net method are:

Gross Method			Net Method		
When purchase took place					
Purchases	100,000		Purchases	98,000	
Accounts Payable		100,000	Accounts Payable		98,000
Paid the accounts payable within the discount period					
Accounts Payable	100,000		Accounts Payable	98,000	
Purchase Discount		2,000	Cash		98,000
Cash		98,000			
Paid the accounts payable beyond the discount period					
Accounts Payable	100,000		Accounts Payable	98,000	
Cash		100,000	Purchase Discount Lost	2,000	
			Cash		100,000

Under **Net Method**, if payment is not made yet at the reporting date and the discount period has already lapsed, an adjusting entry is needed to record as follows:

Purchase Discount Lost	2,000	
Accounts Payable		2,000

This adjusting entry brings the accounts payable balance to P100,000. The adjustment is made to reflect in the accounts the accurate amount of the resources expected to be given upon settlement of the obligation in the subsequent period.

Under **Gross Method**, year-end adjustment is necessary if the account has not yet been paid at year-end but subsequently settled during the subsequent reporting period within the discount period. The adjustment is not necessarily made at year-end but is dated at the end of the year. Adjusting entry is:

Allowance for Purchase Discount	XX	
Purchase Discount		XX

The entry reduces the amortized cost of accounts payable to the amount of cash that would be disbursed to settle the account in the subsequent period. The adjustment also matches properly the purchase discounts against the recorded purchases in the same reporting period. The account “Allowance for Purchase Discount” is deducted from Accounts Payable in the statement of financial position, while the Purchase Discount account reduces the recorded cost of Purchases that is shown in the statement of comprehensive income. On the first day of the subsequent reporting period, such adjustment is reversed, so that the payment of account is made in the usual manner, as follows:

Accounts Payable	XX	
Purchase Discounts		XX
Cash		XX

NOTES PAYABLE

Notes Payable are written promises to pay a certain sum of money on a specified future date. They may arise from purchases, financing, or other transactions. Some industries require notes as part of the sales/purchases transaction in lieu of the normal extension of open account credit, this is referred to as trade notes payable. Notes payable to banks or loan companies generally arise from cash loans and these are classified as non-trade notes payable.

Companies classify notes as short-term or long-term, depending on the payment due date. Trade notes payable is generally classified as current. Non-trade notes payable that are due and payable within one year are treated as current. Whereas, if maturing beyond one year, it is classified as noncurrent liability.

Notes may also be interest-bearing or non-interest-bearing. A non-interest-bearing note does not explicitly state an interest rate on the face of the note. Interest is still charged, however.

Illustrations: Accounting for Interest-bearing notes payable

1. On July 1, 2020, Smart Company issued a 90-day, 10% notes for P200,000 to SMC Company to settle its overdue account. (trade notes payable).

   The entry by Smart Company to record the issuance of the notes is:

July 1-	Accounts Payable	200,000	
	Notes Payable		200,000

   The payment of the notes payable on September 29, its due date was recorded by Smart with the following entry:

Sept. 29	Notes Payable	200,000	
	Interest Expense	5,000	
	Cash		205,000

   How to compute for the amount of interest:

Face value of the note	P200,000
Multiply by interest rate and term of the note/360 days	X 10% X 90/360
Interest of the note for 90 days	P5,000

   How to determine the due date/maturity date of notes:

Term of the note		90 days
Number of days in July	31	
Date of the note, July	1	30
Days in August		31
Due date of note, September		**29**
Total number of days		90 days

2. Interest bearing notes issued for property acquired. (non-trade notes payable)
On January 1, 2020, Smart Company purchased a parcel of land with a cost of P1 million pesos. A down payment of P400,000 was made and issued a promissory note for P600,000 bearing interest of 10% per annum. The P600,000 is payable in four annual installment of P150,000 every January 1.

Entries to record transactions relating to the notes up to year 2022, are as follows:

Date	Account	Debit	Credit
2020			
Jan. 1	Land	1,000,000	
	Cash		400,000
	Notes Payable		600,000
Dec. 31	Interest Expense	60,000	
	Interest Payable		60,000
	To record accrued interest of the notes Payable for the period Jan. 1 to Dec. 31, 2020. (600,000 x 10% =P60,000).		
2021			
Jan. 1	Notes Payable	150,000	
	Interest Payable	60,000	
	Cash		210,000
	To record the first annual payment of principal and interest.		
Dec. 31	Interest Expense	45,000	
	Interest Payable		45,000
	To take up accrued interest of the outstanding balance of the note from Jan. 1, 2021 to Dec. 31, 2021. ((450,000 x .10 =P45,000)		
2022			
Jan. 1	Notes payable	150,000	
	Interest payable	45,000	
	Cash		195,000
	2nd annual payment.		
Dec. 31	Interest Expense	30,000	
	Interest Payable		30,000
	Interest for year 2022 of the P300,000 outstanding balance of the notes payable.		

Every December 31, adjusting entry must be prepared to take up the accrued interest on the notes payable.

3. Note issued for cash borrowed (wherein the interest is deducted in advance).

Illustration:

On November 1, 2020, Smart Company discounted its own note of P1,000,000 at 12% for one year.

The entry of Smart on November 1, to record the note issued is:

Cash	880,000	
Discount on notes payable	120,000	
Notes Payable		1,000,000

Computation of proceeds:

Face value of notes payable	P1,000,000
Less: Discount (P1,000,000 x 12%)	120,000
Proceeds	P880,000

The discount on notes payable of P120,000 is the interest for one year deducted in advance. On December 31, adjusting entry to amortize the discount must be prepared. The amortization is for the period November 1 to December 31 (2 months). The entry to amortize the discount on Dec. 31, 2020 is:

Interest Expense	20,000	
Discount on notes payable		20,000
(P120,000 x 2 mos./12)		

On November 1, 2020, the carrying value of the notes payable is P880,000. That is;

Face value of the note	P1,000,000
Less: unamortized discount	120,000
Carrying value	P880,000

On December 31, 2020, the carrying value of the above notes payable is P900,000. That is;

Face value of the note	P1,000,000
Less: unamortized discount(P120,000-20,000)	100,000
Carrying value of note	P900,000

On the due date of the note, which is on October 31, 2021, The entries to amortized the unamortized discount of P100,000 and the payment of the note are as follows:

Interest Expense	100,000	
Discount on notes payable		100,000
Notes Payable	1,000,000	
cash		1,000,000

Accounting for noninterest-bearing notes payable

A noninterest-bearing notes payable does not explicitly state an interest rate on the face of the note. It does not mean, however, that there is no interest imputed on the note. A noninterest-bearing note is simply written in a form where the interest is imputed on the face value of the note. Thus, the face value represents the present value of the note plus the imputed interest. The imputed interest is based on the sound philosophy that no lender would part away with his money or property interest-free.

Non-interest bearing note issued for property

When a non- interest-bearing note is issued for property, the property is recorded at the **cash price** of the property. The cash price is assumed to be the present value of the note issued. The difference between the cash price and the face value of the note issued represents the imputed interest.

Illustrations:

1. On January 1, 2020, SOMO company acquired an equipment with a **cash price** of P350,000 for P500,000. SOMO Paid down payment of P100,000 and issued a noninterest-bearing notes payable for P400,000, payable in 4 equal annual installment of P100,000 every December 31.

The difference between P500,000 and the cash price of P350,000 represents the imputed interest which is debited to the account discount on notes payable. The discount on notes payable is periodically amortize by charging it to the account interest expense.

Using the amortization table below, the entries to record the above transaction for year 2020-2023, are as follows:

2020			
Jan. 1	Equipment	350,000	
	Discount on notes payable	150,000	
	Cash		100,000
	Notes payable		400,000
Dec. 31	Notes Payable	100,000	
	Cash		100,000
	Paid first annual installment.		
31	Interest Expense	60,000	
	Discount on notes payable		60,000
	Amortization of discount on notes payable for year 2020		
2021			
Dec. 31	Notes Payable	100,000	
	Cash		100,000
	Paid second annual installment.		
Dec. 31	Interest Expense	45,000	
	Discount on notes payable		45,000
	Amortization of discount for 2021.		
2022			
Dec. 31	Notes Payable	100,000	
	Cash		100,000
	3rd annual payment		
Dec. 31	Interest Expense	30,000	
	Discount on notes payable		30,000
	Amortization of discount for 2022.		

2023

Dec. 31	Notes Payable	100,000	
	Cash		100,000
	Last payment of notes payable		
Dec. 31	Interest Expense	15,000	
	Discount on notes payable		15,000
	Last amortization of discount.		

Table of Amortization

year	Notes Payable Outstanding balance	fraction	Amortization Of discount
2020	400,000	4/10	60,000
2021	300,000	3/10	45,000
2022	200,000	2/10	30,000
2023	100,000	1/10	15,000
	1,000,000		150,000

2. **Non-interest bearing note issued for property (the cash price of the asset acquired is not known).**
   On January 1, 2020, SOMO Company acquired an equipment for P1,000,000. The company issued a noninterest-bearing note for P1,000,000 payable in 5 equal annual payment of P200,000, every December 31. Assuming that the prevailing interest rate is 10%, the present value of an ordinary annuity o 1 for 5 year at 10% is 3.7908. The cost of the equipment is equal to the present value of the notes payable issued, computed as follows:

Annual installment	P200,000
Multiplied by the present value factor	3.7908
Present value of the P1 M notes payable	P758,160

Face value of the notes payable	P1,000,000
Present value of notes payable	758,160
Discount on notes payable	P241,840

The journal entries for year 2020, are:

Jan. 1	Equipment	758,160	
	Discount on notes payable	241,840	
	Notes Payable		1,000,000
Dec.31	Notes payable	200,000	
	Cash		200,000
	First installment payment.		
Dec.31	Interest Expense	75,816	
	Discount on notes payable		75,816
	Amortization for year 2020.		

Table of Amortization

Date	Payment	Interest	Principal	Present value
Jan. 1, 2020				758,160
Dec. 31,2020	200,000	75,816	124,184	633,976
Dec. 31,2021	200,000	63,398	136,602	497,374
Dec. 31,2022	200,000	49,737	150,263	347,111
Dec. 31,2023	200,000	34,711	165,289	181,822
Dec. 31,2024	200,000	18,178	181,822	-

Interest is equal to the preceding present value multiplied by the implied interest rate. Thus, for year 2020, P758,160 x 10% equals P75,816.

Principal is the periodic payment after deducting the interest. Thus, for year 2020, P200,000 – P75,816 = P124,184.

Present value is the balance of the preceding present value after deducting the portion of payment applied to principal. Thus, for year 2020, P758,160-P124,184=P633,976.

3. Noninterest-bearing notes payable issued for property acquired. (the note is payable in lump-sum)

On January 1, 2020, Tiktok Company acquired Land for P1,000,000. Tiktok paid a down payment if P100,000 and signed a promissory note for P900,000 which is due after three year on January 1, 2023. There was no established cash price for the equipment. The prevailing interest rate for this type of note is 10%. The present value of 1 for 3 periods is .7513.

Computations:

1. Present value of the notes payable

Lump sum payment	P900,000
Multiplied by present value factor	.7513
Present value of the P900,000 notes payable	P676,170

2. Cost of land

Down payment	P100,000
Add: Present value of the notes payable	676,170
Cost of Land	P776,170

3. Discount on notes payable

Face value of the note payable	P900,000
Less: Present value of the note	676,170
Discount on notes payable	P223,830

Table of Discount Amortization

Date	Discount amortization	Balance of discount	Present value of notes payable
Jan. 1, 2020		223,830	676,170
Dec. 31, 2020	67,617	156,213	743,787
Dec. 31, 2021	74,379	81,834	818,166
Dec. 31, 2022	81,834	-	900,000

The present value of the notes payable is equals to face value minus the unamortized discount. Thus, on December 31, 2020, the present value or carrying value of the notes payable of P743,787 is P 900,000 minus P156,213. On December 31, 2021, P900,000 minus P81,834 equals P818,166.

The entries relating to the above notes payable are:

2020			
Jan. 1	Land	776,170	
	Discount on notes payable	223,830	
	Cash		100,000
	Notes payable		900,000
Dec. 31	Interest expense	67,617	
	Discount on notes payable		67,617
	Discount amortization for 2020.		

The discount on notes payable is amortized using the effective interest method, computed by multiplying the preceding present value by the assumed interest rate. At maturity date of note, its face value and present value are equal.

The entry to record the payment of the note on January 1, 2023, its due date would be:

Jan. 1, 2023	Notes Payable	900,000	
	cash		900,000

A noninterest-bearing note may also be issued for money borrowed from a bank or a financing company. The present value of such note is equal to the proceeds received. The difference between the face value of the note and the proceeds received is the interest which is debited to the account discount on notes payable.

Illustration: On April 1, 2020, Covie Company discounted its own one-year P150,000, noninterest-bearing note with Metrobank at a discount rate of 10%. Covie will receive proceeds of P135,000 from this loan. That is, P150,000 less P15,000 discount (10% of P150,000).

On issue date, April 1, 2020, the carrying value of the notes payable is P135,000. That is,

Face value of notes payable	P150,000
Less: unamortized discount	15,000
Carrying value	P135,000

On December 31, 2020, the carrying value of the note is:

Face value of notes payable	P150,000
Less: unamortized discount (P15,000-11,250)	3,750
Carrying value	P146,250

The entries relating to the above transaction are as follows:

2020			
April 1	Cash	135,000	
	Discount on notes payable	15,000	
	Notes payable		150,000
	Obtained loan from Metrobank.		

Dec. 31	Interest Expense	11,250	
	Discount on notes payable (15,000x9/12)		11,250
	Amortization of discount from Apr. to Dec.		
2021		150,000	
Mar. 31	Notes payable		
	Cash		150,000
	Payment of notes payable.		
Mar. 31	Interest Expense	3,750	
	Discount on notes payable (15,000x3/12)		3,750
	Amortization of the remaining discount.		

Interest bearing notes payable is presented in the statement of financial position at face value. Whereas noninterest-bearing notes payable is presented at present value.

BONDS PAYABLE

A bond is a certificate of indebtedness whereby the borrower agrees to pay a sum of money at a specified future date plus periodic interest payments at the stated rate. They are commonly issued in denominations of P1,000, P5,000, or P10,000, referred to as face value or par value. A corporation may sell all of its bonds to an investment firm or underwriter, which resell the bonds to the investing public. Bonds may also be sold directly to the investor.

The contract between the issuing corporation and the bondholder is known as **bond indenture.** The bond indenture specifies the terms of the bonds, rights and duties of both parties, restrictions and all other important details affecting the contracting parties.

Types of bonds:

Term bonds	-bonds that mature on a single date.
Serial bonds	-bonds that mature in installment.
Secured bonds	-are those that provide security and protection to investor in the form of specific assets of the issuer, such as real estate or other collateral.
Unsecured bonds	-or frequently called debentures, are not protected by the pledge of any specific asset of the issuing corporation. The issue of debenture bonds is generally based on the issuer's favorable credit rating.
Registered bonds	-are bonds whose owner's names are registered in the books of the issuing corporation. When these bonds are sold, the transfer agent cancels the original certificate surrendered by the seller and a new certificate is issued and registered in the name of the new bondholder.
Bearer bonds of coupon bonds	-are not recorded in the name of the owner. Each bond is accompanied by coupons representing periodic interest payments, covering the life of the issue.

Callable/redeemable bonds	-are those that give the issuing corporation the right to call or retire the bonds before maturity date, usually specified on the bond indenture.
Convertible bonds	-are those that give the bond holder the right to exchange their bond holdings into a specified or predetermined number of the issuing corporation's shares of stock.
Zero-interest bonds	-are issued at significantly lower than their face value. Total interest on these bonds during their entire term is paid together with the principal amount on maturity date.

Bond liabilities are initially recognized at their discounted value, which equals the net proceeds from their issuance. The issue price is the market price of the bond. The rate of interest stated on the face of the bond is the contract rate/stated rate or nominal rate of interest. This interest rate generally depends on the financial condition and earnings of the issuing corporation.

The interest rate which investor are willing to accept at the time of the bond issue depends upon some factor such as the market evaluation of the quality of the bond issue as evidenced by the financial strength of the business, the firm's earnings prospects and the particular provisions of the bond issue. This rate is referred to as the market rate/yield rate, or effective interest rate.

The sale of bonds at face value implies that the bonds stated interest rate is in agreement with the market interest rate. Whereas bonds issued above its face value indicates that the bond's stated interest rate is higher that the market rate. In this case, the bonds will be sold at a premium. On the other hand, if the stated rate is lower than the market rate, the issue price would be lower than its face value. That is, the bonds will be sold at a discount.

Bond prices are quoted in the market as a percentage of face value. For example, a bond quoted at 97 means that the market price is 97% of face value. Thus, the bond is selling a discount. A quotation of 105 means that the market price is 105% of the face value. Thus, the bond is selling at a premium.

Bonds issue costs are expenditures incurred by the issuing company for legal fees, printing and engraving of bond certificates, taxes, commissions, and other charges. These costs form part of the initial carrying amount of the bond liability. The net proceeds from bond issue is reduced by the incurrence of bond issue costs. The amount of bond premium or discount is the difference between the face value of the bonds and the net proceeds. In effect, bond issue cost is being offset to the bond premium/discount. The entry to record bond issue cost is:

If bond is sold at a premium:

Premium on bonds	xxx	
Cash		xxx

If bond is sold at a discount:

Discount on bonds	xxx	
Cash		xxx

ISSUANCE OF BONDS

Illustrations:

1. Bonds issued at face value (at par)-the stated interest rate and the effective rate are the same

On January 1, 2020, Orange Company issued a 5-year, P2,000,000, **10%** bonds at par. The effective interest rate for similar bonds is **10%**. Interest is payable semi-annually every January 1 and July 1. The entries for year 2020, to record transactions relating to the above bonds are:

2020			
Jan. 1	Cash	2,000,000	
	Bonds Payable		2,000,000
July 1	Interest expense	100,000	
	Cash (2,000,000 x 10% x 6/12)		100,000
	Paid semi-annual interest.		
Dec. 31	Interest expense	100,000	
	Interest payable		100,000
	Accrued interest July to December.		

2. Bonds issued at a premium (above par. The stated interest rate of 15% is higher that the 12% effective rate)

On January 1, 2017, Orange Company issued a 5-year, P1,000,000, **15%** bonds for P1,110,401. The effective interest rate for similar bonds is **12%**. Interest is payable semi-annually every January 1 and July 1. The entries for year 2017 and 2018 to record transactions relating to these bonds are:

2017			
Jan. 1	Cash	1,110,401	
	Bonds Payable		1,000,000
	Premium on bonds payable		110,401
July 1	Interest expense	75,000	
	Cash (2,000,000 x 10% x 6/12)		75,000
	Paid semi-annual interest.		
July 1	Premium on bonds payable	8,376	
	Interest expense		8,376
	First amortization of bond premium.		
Dec. 31	Interest expense	75,000	
	Interest payable		75,000
	Accrued interest, July to December.		
Dec.31	Premium on bonds payable	8,878	
	Interest expense		8,878
	2nd amortization of bond premium.		

Below is the amortization table of the bond premium for the entire term of the bond using the effective interest method.

Schedule of Bond Premium Amortization
Effective-Interest Method—Semiannual Interest Payments
5-Year, 15% Bonds Sold to Yield 12%

Date	(A) Nominal interest FV x stated rate	(B) Effective interest CV x effective rate	(C) Amortization (A) – (B)	(D) Bond Carrying Value Previous (D) –(C)
01/01/17				1,110,401
07/01/17	75,000	66,624	8,376	1,102,025
12/31/17	75,000	66,122	8,878	1,093,147
07/01/18	75,000	65,589	9,411	1,083,736
12/31/18	75,000	65,024	9,976	1,073,760
07/01/19	75,000	64,426	10,574	1,063,186
12/31/19	75,000	63,791	11,209	1,051,977
07/01/20	75,000	63,199	11,881	1,040,096
12/31/20	75,000	62,406	12,594	1,027,502
07/01/21	75,000	61,650	13,350	1,014,152
12/31/21	75,000	60,848	14,152	1,000,000

It is to be noted, that premium amortization decreases both the carrying value of the bond and the interest expense. On maturity date, after the premium amortization for the entire term of the bond, its carrying value of the bond will be equal to its face value. Premium on bonds payable is an addition to the bonds payable. On December 31, 2017, the above bonds were presented in the statement of financial position as follows:

Noncurrent Liabilities:		
Bonds Payable	P1,000,000	
Add: Unamortized premium (110,401 - 8,376)	102,025	P1,102,025

At maturity date, the entry to record the payment of the bonds would be as follows:

Bonds Payable	75,000	
Cash		75,000

3. Bonds issued at a discount (below par, with bond issue costs incurred)

A 5year, 12%, bonds with a face value of P1,000,000 were sold for P917,039 on January 1, 2020. The issuer incurred a bond issue costs of P20,000. The bonds pay interest every July 1 and January 1. The yield on the net proceeds is computed at 15%. Below is the amortization table of the bond discount using the effective interest method.

Bond Discount Amortization Table
Effective Interest Method

Date	A Nominal Interest P1Mx6%	B Effective Interest Previous D x7.5%	C Discount Amortization(B-A)	D Bond Carrying value(D+C)
01/01/20				897,039*
07/01/20	60,000	67,278	7,278	904,317

12/31/20	60,000	67,824	7,824	912,141
01/01/21	60,000	68,410	8,410	920,551
12/31/21	60,000	69,041	9,041	929,592
01/01/22	60,000	69,719	9,719	939,311
12/31/22	60,000	70,448	10,448	949,759
01/01/23	60,000	71,232	11,232	960,991
12/31/23	60,000	72,074	12,074	973,065
01/01/24	60,000	72,980	12,980	986,045
12/31/24	60,000	73,957	13,955	1,000,000

- The carrying value of the bond on January 1, 2020 is computed as follows:

Issue price of bonds	P917,039
Less: bond issue costs	20,000
Net proceeds (Carrying value of bonds, Jan. 1, 2020	P897,039

The difference between the face value of the bonds and the net proceeds is the discount on bonds. That is,

Face value of bonds	P1,000,000
Net proceeds	897,039
Discount on bonds	P102,961

The journal entries for the year 2020 and 2021 relating to the above bonds are as follows:

2020			
Jan. 1	Cash	917,039	
	Discount on bonds payable	82,961	
	Bonds Payable		1,000,000
Jan. 1	Discount on bonds payable	20,000	
	Cash		20,000
	Bond issue costs incurred.		
July 1	Interest expense	60,000	
	Cash		60,000
	Paid semi-annual interest		
July 1	Interest expense	7,278	
	Discount on bonds payable		7,278
	First amortization of discount on bonds.		
Dec. 31	Interest expense	60,000	
	Interest Payable		60,000
	To take up accrued interest on bonds		
Dec. 31	Interest expense	7,824	
	Discount on bonds payable		7,824
	2nd amortization of discount on bonds.		
2021			
Jan. 1	Interest Payable	60,000	
	Cash		60,000
	Paid semi-annual interest of bonds.		

July 1	Interest expense	60,000	
	Cash		60,000
	Paid semi-annual interest of bonds.		
July 1	Interest expense	8,410	
	Discount on bonds payable		8,410
	3rd amortization of discount.		
Dec. 31	Interest expense	60,000	
	Interest Payable		60,000
	To take up accrued interest on bonds.		
Dec. 31	Interest expense	9,041	
	Discount on bonds payable		9,041
	To amortize discount on bonds.		

If amortization of bond premium **decreases** both the bonds carrying value and interest expense, the amortization of bond discount**, increases** both the bonds carrying value and interest expense. Discount on bonds payable is a deduction from the bonds payable. On December 31, 2020, the above bonds will be presented in the statement of financial position as follows:

Noncurrent Liabilities:		
Bonds Payable	P1,000,000	
Less: Unamortized discount (P102,961- 7,278)	95,683	904,317

The amortization of bond premium/discount may be on every interest payment date or at the end of every year.

Bonds issued between interest payment dates

If bonds are issued between interest payment date, an accrued interest is involved. Normally, the accrued interest is paid by the buyer or investor. Since the issuing corporation will pay the full periodic interest on the bonds outstanding at interest date, the bondholder is usually required to pay the interest that has accrued from the most previous interest date to the date of sale.

Illustration:

On April 1, 2020, a Corporation issued bonds with a face amount of P5,000,000 at P5,228,000 plus accrued interest. The bonds are dated January 1, 2020, mature in 5 year and pay 12% interest semiannually on January 1 and July 1.

Computation of proceeds:

Issue price	P5,228,000
Add: Accrued interest (from Jan.1 to Apr.1, 2020) (P5,000,000 x12% x 3/12)	150,000
Total cash received	P5,378,000

The entry to record the issuance of the above bonds is:

Cash	5,378,000	
Bonds payable		5,000,000
Premium on bonds payable		228,000
Interest expense		150,000

The accrued interest on the date of sale for 3 months from January 1 to April 1, 2020 is paid by the investor because on July 1, 2020, the investor will receive interest for 6 months, that is from January 1 to July 1. On July 1, 2020, the journal entry to record the payment of semiannual interest is as follows:

Interest Expense	300,000	
Cash		300,000
(P5,000,000 x 12% x 6/12 = P300,000)		

Retirement of Bonds on maturity date

The issuing corporation may retire bonds at maturity date or before the maturity date. If bonds are retired at maturity date, any premium or discount must have been completely amortized. The amount paid to the bond holder equals the face value of the bonds. The retirement is recorded as an ordinary payment of debt. No gain or loss is recognized upon retirement of bonds on maturity date. Thus, the entry is:

Bonds Payable	xx	
Cash		xx

Retirement of Bonds prior to maturity date

If bonds are retired before maturity date, the following procedures are to be followed:

a) The amortization of premium/discount must be updated to determine the carrying value
of the bonds at the date of retirement.

b) Any accrued interest on the retired bonds from the most recent interest payment date up to the date of retirement must be recorded and paid.

c) Determine the gain/ loss on the early retirement of bonds to be recognized.

Illustrations:

1. A 15%, P1,000,000 bonds were issued on January 1, 2017 for P1,110,401, a price that provides a yields of 12%. Interest is payable semi-annually on June 30 and December 31. On October 31, 2020, The P1,000,000 bonds were retired at 102 plus accrued interest.

On October 31, 2020, the issuer should update the interest and amortization of premium with the following entry:

Interest Expense (1,000,000 x 15% x 4/12)	50,000	
Interest Payable		50,000
Interest from July 2020 to Oct. 31, 2020.		
Premium on bonds payable (12,594* x 4/6)	8,396	
Interest Expense		8,396
Amortization from July 2020 to Oct. 31, 2020.		

*Please refer to the premium amortization table in the previous illustration.

Computation of the carrying value of the bonds on the retirement date.

Carrying value of bonds on July 1, 2020	P1,040,096
Less: premium amortization (July 1, 2020 to Oct. 31, 2020)	8,396
Carrying value of bonds on the retirement date (Oct. 31, 2020)	P1,031,700

Computation of gain(loss) on the early retirement of bonds.

Retirement Price (P1,000,000 x 102%)	P1,020,000
Carrying value of bonds on retirement date	1,031,700
Gain on retirement of bonds	P11,700

If the retirement price is less than the carrying value of bonds retired, the difference is gain. If the retirement price is more than the carrying value of bonds retired, the difference is loss.

Computation of total amount to be paid by the issuer of bonds.

Retirement Price	P1,020,000
Add: Accrued interest from July 1, 2020 to Oct. 31, 2020 (P1,000,000 x 15% x 4/12)	50,000
Total cash to be paid on the early retirement of bonds	P1,070,000

Entry to record the retirement of bonds:

Bonds Payable	1,000,000	
Premium on bonds payable (unamortized balance)	31,700	
Interest Payable	50,000	
Cash		1,070,000
Gain on early retirement of bonds		11,700

TROUBLED-DEBT RESTRUCTURING

Some debtors experience difficulties in meeting their maturing obligations. For this reason, the creditor may grant concession to the debtor that it would not otherwise grant under normal conditions. This is called troubled debt restructuring. An entity shall remove a financial liability from its statement of financial position when it is extinguished.

Troubled debt restructuring may consist of the following:

a. Asset swap
b. Equity swap
c. Modification of terms

a. **Asset swap** is a settlement of debt by a transfer of non-cash assets like, real estate, receivables or other assets. Asset swap may result to a gain or loss on the disposal of the asset used as payment for the debt. A gain or loss is also computed for the difference between the carrying value of the debt and the fair value of the asset swapped.

Illustration: (Asset swap)

BGC Corporation has outstanding loans payable of P1,000,000 to China Bank with accrued interest of P100,000, that is due on December 31, 2020. Due to depressed economic conditions, BGC would not be able to pay this obligation. China Bank agreed to accept from BGC, equipment with a fair value of P1,000,000 in full settlement of the P1M principal and the P100,000 accrued interest. The equipment cost P1,500,000 with accumulated depreciation of P300,000.

Computation of gain or loss on the disposal of asset:

Cost of equipment transferred	P1,500,000
Less: accumulated depreciation	300,000
Carrying value of equipment	P1,200,000
Fair market value of equipment	1,000,000
Loss on disposal of land	P200,000

If the carrying value of asset disposed is more than its fair market value, the difference is loss. Whereas, if the market value of asset disposed is more than its carrying value, the difference is gain.

Computation of gain or loss on debt restructuring:

Amount of Loans payable	P1,000,000
Add: Accrued interest	100,000
Carrying value of the liability	P1,100,000
Fair market value of asset used as payment	1,000,000
Gain on debt restructuring	P100,000

The entry to record the debt restructuring through asset swap is

Notes payable	1,000,000	
Interest payable	100,000	
Loss on disposal of land	200,000	
Accumulated depreciation	300,000	
Equipment		1,500,000
Gain on debt restructuring		100,000

b. **Equity Swap-** The debtor's financial liability is extinguished by the issuance of the debtor's share capital or other equity instruments.

Illustration: (Equity Swap)
Coie Corporation has outstanding loans payable of P10,000,000 to Metrobank with accrued interest of P1,200,000, that is due on December 31, 2020. Due to depressed economic conditions, Coie would not be able to pay this obligation. Metrobank agreed to accept Coie's 180,000 ordinary shares. Coie's ordinary shares has par value of P50 and a fair market value of P60.

Computation of gain or loss on debt restructuring:

Carrying value of debt settled (P10,000,000 + 1,200,000)	P11,200,000
Fair market value of shares issued (180,000sh. X P60)	10,800,000
Gain on debt restructuring	P400,000

Computation of additional paid-in capital on shares issued:

Fair market value of shares issued (180,000sh. X P60)	P10,800,000
Par value of shares issued (180,000 sh. X P50)	9,000,000
Additional paid-in capital	P1,800,000

The entry to record equity swap is:

Notes payable	10,000,000	
Interest payable	1,200,000	
Ordinary share capital		9,000,000
Additional paid-in capital		1,800,000
Gain on debt restructuring		400,000

c. Modification of terms-debt restructuring under modification of terms may take the form of one or any combination of the following:
   a. Reduction of stated interest rate
   b. Reduction of the face amount of the debt
   c. Reduction or condonation of accrued interest

d. Extension of the maturity date
e. Moratorium on the payment of interest and/or principal

Illustration: (Modification of terms)
Cove Corporation has outstanding loans payable of P10,000,000 to Metrobank with accrued interest of P1,200,000, that is due on December 31, 2020. Due to depressed economic conditions, Cove would not be able to pay this obligation. Metrobank agreed to the following modifications on December 31, 2020.

* Reduction of principal from P10,000,000 to P7,000,000
* Condonation of accrued interest
* Extension of maturity date to December 31, 2022, and
* Reduction of interest rate from 12% to 8%

The gain or loss on debt restructuring is computed as follows:

Discounted amount of the total future payments under the new terms:		
Present value of the new principal amount (P7M x 0.63552)	P4,448,640	
Present value of the interest payments (P7M x 8%) x 3.03735	1,700,916	
Total present value of future payments		P6,149,556
Carrying value of the debt restructured (P10M + 1,200,000)		11,200,000
Gain on debt restructuring		P5,050,444

The total discounted present value of future cash payments under the new terms is determined using the original effective interest rate.

The entry to record the debt restructuring under modification of terms is:

Notes Payable	10,000,000	
Interest Payable	1,200,000	
Restructured notes payable		6,149,556
Gain on debt restructuring		5,050,444

ASSESSMENT ACTIVITIES

PROBLEMS

Show your complete solution, in good accounting form, on a separate sheet of paper.

1. On April 1, 2020, SAM Company issued a P9,000,000 noninterest-bearing note due on March 31, 2023 for a piece of land with a cash price of P6,949,800.

   Required:
   a. Determine the effective interest rate of the note
   b. Prepare the discount amortization table over the term of the note
   c. Prepare the entries for year 2020 through 2023, including any year-end adjustments.

2. Shopee Company was authorized to issue a 5-year, 10%, P5,000,000 bonds dated June 30, 2020. Interest is payable semi-annually on June 30 and December 31. (The company uses the effective interest method of amortization). Assuming the bonds were sold to yield:
   a.) at 8%   b.) at 12%

   Required:
   a. Determine the issue price of the bonds.

b. Prepare the amortization table for the entire life of the bonds
c. Prepare the entries relating to the bonds for the year 2020 and 2021.

Multiple Choice-Theory

1. An entity shall measure initially a financial liability not designated at fair value through profit/loss at
   a. Fair Value
   b. Fair value plus directly attributable transaction costs
   c. Fair value minus directly attributable transaction costs
   d. Face amount

2. Which of the following is not an essential characteristic for an item to be reported as a liability on the balance sheet?
   a. The liability is the present obligation of a particular enterprise
   b. The liability arises from past transactions or events
   c. The liability is payable to a specifically identified payee
   d. The settlement of the liability requires an outflow of resources embodying economic benefits

3. The covenants and other terms of the agreement between the issuer of bonds and the lender are set forth in the
   a. bond indenture b. bond debenture c. registered bond d. bond coupon

4. The rate of interest actually earned by bondholder is called the
   a. stated rate only
   b. yield rate only
   c. effective rate only
   d. effective, yield or market rate

5. Rich, Inc. issued bonds with a maturity amount of P200,000 and a maturity ten year from date of issue. If the bonds were issued at a premium, this indicates that
   a. the effective yield or market rate of interest exceeded the stated (nominal) rate.
   b. the nominal rate of interest exceeded the market rate.
   c. the market and nominal rates coincided.
   d. no necessary relationship exists between the two rates.

6. Under the effective-interest method of bond discount or premium amortization, the periodic interest expense is equal to
   a. the stated (nominal) rate of interest multiplied by the face value of the bonds.
   b. the market rate of interest multiplied by the face value of the bonds.
   c. the stated rate multiplied by the beginning-of-period carrying amount of the bonds.
   d. the market rate multiplied by the beginning-of-period carrying amount of the bonds.

7. When the effective-interest method is used to amortize bond premium or discount, the periodic amortization will
   a. increase if the bonds were issued at a discount.
   b. decrease if the bonds were issued at a premium.
   c. increase if the bonds were issued at a premium.
   d. increase if the bonds were issued at either a discount or a premium.

8. If bonds are issued between interest dates, the entry on the books of the issuing corporation could include a

a. debit to Interest Payable.
b. credit to Interest Receivable.
c. credit to Interest Expense.
d. credit to Unearned Interest.

9. When the interest payment dates of a bond are May 1 and November 1, and a bond issue is sold on June 1, the amount of cash received by the issuer will be
   a. decreased by accrued interest from June 1 to November 1.
   b. decreased by accrued interest from May 1 to June 1.
   c. increased by accrued interest from June 1 to November 1.
   d. increased by accrued interest from May 1 to June 1.

10. The printing costs and legal fees associated with the issuance of bonds should
   a. be expensed when incurred.
   b. be reported as a deduction from the face amount of bonds payable.
   c. be recorded as a reduction of the bond issue amount and then amortized over the life of the bonds.
   d. not be reported as an expense until the period the bonds mature or are retired.

11. The amortization of a premium on bonds payable
   a. decreases the balance of the bonds payable account.
   b. increases the amount of interest expense reported.
   c. increases the carrying amount of the bond.
   d. increases the cash payment to bondholder.

12. A debt instrument with **no** ready market is exchanged for property whose fair value is currently indeterminable. When such a transaction takes place
   a. the present value of the debt instrument must be approximated using an imputed interest rate.
   b. it should not be recorded on the books of either party until the fair value of the property becomes evident.
   c. the board of director of the entity receiving the property should estimate a value for the property that will serve as a basis for the transaction.
   d. the director of both entities involved in the transaction should negotiate a value to be assigned to the property.

13. When a note payable is issued for property, goods, or services, the present value of the note may be measured by
   a. the fair value of the property, goods, or services.
   b. the fair value of the note.
   c. using an imputed interest rate to discount all future payments on the note.
   d. All of these answer choices are correct.

14. A discount on notes payable is charged to interest expense
   a. equally over the life of the note.
   b. only in the year the note is issued.
   c. using the effective-interest method.
   d. only in the year the note matures.

15. In a debt extinguishment in which the debt is continued with modified terms and the carrying value of the debt is more than the fair value of the debt,

a. a loss should be recognized by the debtor.
b. a new effective-interest rate must be computed.
c. a gain should be recognized by the debtor.
d. no interest expense should be recognized in the future.

16. In a debt extinguishment in which the debt is settled by a transfer of assets with a fair value less than the carrying amount of the debt, the debtor would recognize
a. no gain or loss on the settlement.
b. a gain on the settlement.
c. a loss on the settlement.
d. None of these answer choices are correct.

17. Long-term debt that matures within one year and is to be converted into shares should be reported
a. as a current liability.
b. in a special section between liabilities and equity.
c. as part current and part non-current.
d. as non-current if the refinancing agreement is completed by the end of the year.

Multiple Choice-Problem

1. The balance in Coco Company accounts payable account at December 31, 2020 was P3,550,000 before any necessary year-end adjustments relating to the following:

- Goods were in transit to Coco from a vendor on December 31, 2020. The invoice cost was P150,000. The goods were shipped FOB shipping point on December 29, 2020 and were received on January 2, 2021.
- Goods shipped FOB destination on December 21, 2020; from a vendor to Coco, were received on January 6, 2021. The invoice cost was P96,000
- On December 27, 2020, Coco wrote and recorded checks totaling P180,000 which were mailed on January 10, 2021.

In Coco's December 31, 2020 statement of financial position, how much should be the accounts payable?

a. P3,976,000
b. P3,880,000
c. P3,796,000
d. P3,700,000

2. Ever Company issues P10,000,000, 6%, 5-year bonds dated January 1, 2020 on January 1, 2020. The bonds pay interest semiannually on June 30 and December 31. The bonds are issued to yield 5%. The present value factors are:

	2.5%	3.0%	5.0%	6.0%
Present value of a single sum for 5 periods	.88385	.86261	.78353	.74726
Present value of a single sum for 10 periods	.78120	.74409	.61391	.55839
Present value of an annuity for 5 periods	4.64583	4.57971	4.32948	4.21236
Present value of an annuity for 10 periods	8.75206	8.53020	7.72173	7.36009

What are the proceeds from the bond issue?

a.P10,000   b. P10,432,988   c. P10,437,618   d. P10,434,616

3. Farmer Company issues P10,000,000 of 10-year, 9% bonds on March 1, 2020 at 97 plus accrued interest. The bonds are dated January 1, 2020 and pay interest on June 30 and December 31. What is the total cash received on the issue date?

a. P9,700,000 b. P10,225,000 c. P9,850,000 d. P9,550,000

4. A company issues P20,000,000, 7.8%, 20-year bonds to yield 8% on January 1, 2021. Interest is paid on June 30 and December 31. The proceeds from the bonds are P19,604,145. Using effective-interest amortization, how much interest expense will be recognized in 2021?
   a. P780,000 b. P1,560,000 c. P1,568,498 d. P1,568,332

5. A company issues P20,000,000, 7.8%, 20-year bonds to yield 8% on January 1, 2021. Interest is paid on June 30 and December 31. The proceeds from the bonds are P19,604,145. Using effective-interest amortization, what will the carrying value of the bonds be on the December 31, 2021 statement of financial position?
   a. P19,612,643 b. P20,000,000 c. P19,625,125 d. P19,608,310

6. On October 1, 2020 Mack Corporation issued 5%, 10-year bonds with a face value of P1,000,000 at 108 (a 4% yield). Interest is paid on October 1 and April 1, with any premiums or discounts amortized on an effective-interest basis. The entry to record the issuance of the bonds would include
   a. P25,000 credit to Interest Payable.
   b. P80,000 credit to discount on bonds payable
   c. P80,000 debit to premium on bonds Payable.
   d. P80,000 credit to premium on bonds Payable.

7. Using the date for number 6, bond interest expense reported on the December 31, 2020 income statement of Mack Corporation amounts to
   a. P10,800 b. P12,500 c. P13,500 d. P21,600

8. BigBang Company issues P10,000,000, 8%, 10-year bonds at 96.5 on July 1, 2020. Interest is paid on July 1 and January 1. The journal entry to record the issuance will include
   a. a debit to cash for P10,000,000
   b. a credit to cash for P9,650,000
   c. a debit to discount on bonds payable for P350,000
   d. a credit to premium on bonds payable for P350,000

9. The 12% bonds payable of Nyman Co. had a carrying amount of P832,000 on December 31, 2019. The bonds, which had a face value of P800,000, were issued at a premium to yield 10%. Nyman uses the effective-interest method of amortization. Interest is paid on June 30 and December 31. On June 30, 2020, several years before their maturity, Nyman retired the bonds at 104 plus accrued interest. The loss on retirement, ignoring taxes, is
   a. P0 b. P6,400. c. P9,920. d. P32,000

10. On December 31, 2020, Nuke Company is in financial difficulty and cannot pay a note due that day. It is a P600,000 note with P60,000 accrued interest payable to Piper, Inc. Piper agrees to accept from Nuke a building that has a fair value of P590,000, an original cost of P530,000, and accumulated depreciation of P130,000. How much gain on the settlement of debt is to be recognized by Nuke?
   a. P0 b. P10,000 c. P60,000 d. P70,000

11. Using the data for number 10, the gain or loss on the disposal of the building was
   a. P0 b. P190,000 gain c. P60,000 gain d. P70,000 loss

Module 2
NON-FINANCIAL LIABILITIES

Overview

This module includes discussions on non-financial liabilities under IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IFRS 15 Revenue from Contracts with Customers. Topics included are provisions, contingent liabilities, contingent assets, provisions for products and service warranties, provision for customer premium offers, customer loyalty awards, unearned revenues for gift certificates outstanding, deposits and advances, and other accrued liabilities.

Module Objectives

After reading this module, you should be able to:

- ❖ understand the essential characteristics of liabilities;
- ❖ distinguish provisions from contingent liabilities (IAS 37);
- ❖ comprehend the concepts of various non-financial liabilities such as warranties, premiums, unearned revenues, customer loyalty awards, gift certificates outstanding, refundable deposits, advances, accrued liabilities and bonuses;
- ❖ account for different non-financial liabilities after initial recognition;
- ❖ measure on financial liabilities in the statement of financial position; and
- ❖ identify required disclosures for current liabilities and contingencies.

Course Material

PROVISION

- A liability whose existence as of the reporting date is certain however it is uncertain as to timing or amount.

- Recognized in the statement of financial position when, and only when:
  a.) An enterprise has a present obligation (legal or constructive) as a result of past event;
  b.) It is probable (more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation; and
  c.) A reliable estimate can be made of the amount of the obligation.

- The amount recognized as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.
  a.) Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities (expected value method). Where there is a continuous range of possible outcomes and each point in that range is as likely as any other, the midpoint of the range is used.
  b.) Where the effect of time value of money is material, the amount of provision should be the present value of the expenditure expected to be required to settle the obligation.

- Examples of provisions are estimated liabilities such as liabilities for product and service warranties and liabilities arising from customer premium offers.

CONTINGENT LIABILITY

- A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future event and wholly within the control of the enterprise.

- A present obligation that arises from past events but is not recognized because

a.) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or

b.) The amount of the obligation cannot be measured with sufficient reliability.

- An entity should not recognize a contingent liability. An entity should disclose a contingent liability unless the possibility of an outflow of resources embodying economic benefits is remote.

CONTINGENT ASSET

- A possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain events not wholly within the control of the enterprise.

- A contingent asset is not recognized in the books of the entity. A contingent asset should be disclosed where an inflow of economic benefits is probable.

PROVISIONS FOR PRODUCTS AND SERVICE WARRANTIES

- In selling products to customers, contracts may indicate warranty agreements wherein the seller has the responsibility to correct any deficiency in quality, quantity or performance of the merchandise sold, to replace the item or refund the selling price over a specified period of time after the sale.

- Under IFRS 15, Warranty agreements provide assurance that the products will function as intended which is based on agreed-upon specifications, while other warranties provide service other than agreed- upon specifications.

- If the warranty is based on agreed-upon specifications, warranty expense is recognize based on associating cause and effect. The expected costs related to revenues of the period shall be recognized as expenses in the same period in which the sales are recorded, even if the expenditure is to be done in the next accounting period.

- If warranties provide service other than agreed-upon specifications (the customer has the option to buy the warranty separately), the warranty is accounted for as a distinct service and is considered a separate performance obligation.

Illustrative Problem:

Provisions for Product or Service Warranties (Warranties Based on Agreed-Upon Specifications)

ABC Company sells coffee maker machines with a 3-year warranty against hidden defects. ABC Company estimates warranty costs as a percentage of sales which are as follows:

1st year of warranty - 2%
2nd year of warranty – 4%
3rd year of warranty - 6%

Sales and actual repairs for years 2017, 2018 and 2019 are:

2017 – P 4,500,000	2018 – P 6,000,000	2019 – P 7,500,000

Warranty costs

2017 – P 175,000	2018 – P 820,000	2019 – P300,000

The company ends its reporting period every December 31.

Warranty Expense & Warranty Liability for each period is computed and recorded as follows:
Warranty Expense for the period:

2017	2018	2019
P 4,500,000 X 12% = 540,000	P 6,000,000 X 12% = 720,000	P 7,500,000 X 12% = 900,000

Entries:

2017			2018			2019		
Warranty Expense	540,000		Warranty Expense	720,000		Warranty Expense	900,000	
Warranty Liability		540,000	Warranty Liability		720,000	Warranty Liability		900,000

Actual warranty costs entries:

2017			2018			2019		
Warranty Liability	175,000		Warranty Liability	820,000		Warranty Liability	300,000	
Cash, Materials, etc.		175,000	Cash, Materials, etc.		820,000	Cash, Materials, etc.		300,000

Warranty Liability at the end of each period:

Warranty Liability	
1/1/2017	
	540,000
175,000	
12/31/2017	365,000

Warranty Liability	
1/1/2018	365,000
	720,000
820,000	
12/31/2018	265,000

Warranty Liability	
1/1/2019	265,000
	900,000
300,000	
12/31/2019	865,000

Illustrative Problem:
Provisions for product or service warranties (What if sales & repairs occur evenly throughout the year?)

Using the same problem, but assuming sales & repairs occur evenly throughout the year, warranty expense and warranty liability for the period are computed and recorded as follows:

Warranty Expense for the period:

2017	2018	2019
P 4,500,000 X 12% = 540,000	P 6,000,000 X 12% = 720,000	P 7,500,000 X 12% = 900,000

Entries:

2017			2018			2019		
Warranty Expense	540,000		Warranty Expense	720,000		Warranty Expense	900,000	
Warranty Liability		540,000	Warranty Liability		720,000	Warranty Liability		900,000

Actual warranty costs entries:

2017			2018			2019		
Warranty Liability	45,000		Warranty Liability	195,000		Warranty Liability	480,000	
Cash, Materials, etc.		45,000	Cash, Materials, etc.		195,000	Cash, Materials, etc.		480,000

2017 Sales: 4,500,000 x 2% x 1/2

2017 Sales:
4,500,000 x 2% x ½ = 45,000
4,500,000 x 4% x ½ = 90,000
2018 Sales:
6,000,000 x 2% x ½ = <u>60,000</u>
Total (2017 + 2018) **195,000**

2017 Sales:
4,500,000 x 4% x ½ = 90,000
4,500,000 x 6% x ½ = 135,000
2018 Sales:
6,000,000 x 2% x ½ = 60,000
6,000,000 x 4% x ½ = 120,000
2019 Sales:
7,500,000 x 2% x ½ = <u>75,000</u>
Total (2017 +2018 + 2019) **480,000**

Warranty Liability at the end of each period:

2017

Warranty Liability	
1/1/2017	
	540,000
45,000	
12/31/2017	495,000

2018

Warranty Liability	
1/1/2018	495,000
195,000	720,000
12/31/2018	1,020,000

2019

Warranty Liability	
1/1/2019	1,020,000
	900,000
480,000	
12/31/2019	1,440,000

Provisions for Customer Premium Offers

- Businesses may offer gifts in the form of other goods that are distributed to the customers upon showing proofs of purchase at the time of redemption. These gifts are called PREMIUMS.

- Under IFRS 15, the transaction price at the time of sale is recognized partly as revenue which is related to sale of goods to customers and partly as a liability for performance obligation to settle the transfer of the promised premium. The allocation of the transaction price is based on the stand-alone selling prices of the products sold and premiums.

TRANSACTION PRICE → REVENUE – Sales (main product)

TRANSACTION PRICE → LIABILITY – Unearned Revenue for Premium Claims

- Before implementation of IFRS 15, Cost of premiums expected to be redeemed by the customers are recognized as an expense. Associated cause and effect is also used to account for these premiums wherein premium expense is estimated and recognized during the same period of sales.

Illustrative Problem:
Provisions for customer premium offers (in accordance with IFRS 15)

In order to boost its sales, Citea Company launched a promotional program wherein for every 5 bottles of Citea Milk tea returned to the company, customers can receive a Citea milk teacup which costs P 30 each. This cup may be sold for P 50 each. Also, each Citea Milk tea bottle costs P 90. Citea Company estimates that only 75% of Citea Milktea bottles reaching the consumer market will be redeemed. The following are some additional information:

	Units	Amount
Sales of Citea Milktea bottles	250,000	27,500,000
Purchase of premiums	50,000	1,500,000
Premiums distributed	30,000	

The company uses perpetual inventory system to account for its inventories.

To allocate the transaction price based on stand-alone selling prices of the Citea Milktea bottle and Citea Milktea cup:
Transaction price: P 27,500,000

Stand- alone selling price of Citea Milk tea bottles sold =	P 27,500,000
Stand- alone selling price of Citea Milk teacup = ((250,000 x 75%)/ 5) x P 50	1,875,000
Total	P 29,375,000

Sales (Citea Milk tea bottles)
P 27,500,000 X 27,500,000 / 29, 375,000 = **25,744,680.90**

TRANSACTION PRICE P 27,500,000

Liability (Citea Milk teacups)
P 27,500,000 X 1,875,000 / 29, 375,000 = **1,755,319.15**

The entry to record the sale of the product would be:

Cash / Accounts receivable	27,500,000	
Sales		25,744,680.90
Unearned Revenue for Premium claims		1,755,319.15

Cost of goods sold	22,500,000	
Inventory (Citea Milk tea bottles)		22,500,000

The entry to record the purchase of premiums:

Premiums Inventory	1,500,000	
Cash/ Accounts payable		1,500,000

The entry to record the distribution of premiums would be:

Unearned Revenue for Premium claims	1,404,255.32	
Sales		1,404,255.32

P 1,755,319.15 X 30,000 / 37,500 = 1,404,255.32

Cost of goods sold	900,000	
Premiums Inventory		900,000

P 1,500,000 X 30,000 / 50,000 = 900,000

In the statement of financial position as of the end of the year, the balances of Premiums Inventory and the Unearned Revenue for Premium claims are P600,000 and P351,063.83, respectively.

Illustrative Problem:
Provisions for customer premium offers (if premiums are reported as an expense)

Using the information from the previous problem, the following are the entries:

Cash / Accounts receivable	27,500,000	
Sales		27,500,000

Cost of goods sold	22,500,000	
Inventory		22,500,000
Premiums Inventory	1,500,000	
Cash/ Accounts payable		1,500,000
Premium Expense	900,000	
Premiums Inventory		900,000
30,000 x P 30 = 900,000		
Premium Expense	225,000	
Estimated Premium Claims Outstanding		225,000
(250,000 X 75%/5) – 30,000 = 7,500 X P 30 = 225,000		

In the statement of financial position as of the end of the year, the balances of Premiums Inventory and the Estimated Premium Claims Outstanding are P600,000 and P225,000, respectively.

CUSTOMER LOYALTY AWARDS

- Businesses may grant their customers rewards for patronage/loyalty of their products and services.
  Examples: Awarding points to SM Advantage/Prestige Cardholders, SUKI card issued by Mercury Drugs, accumulation of mileage for PAL for frequent flyers and etc.

- By accumulating points, it entitles the holders to exchange points accumulated for future purchases of goods and services of the entity.

- In accordance with IFRS 15, customer loyalty awards on the goods or services sold, the transaction price received or receivable by the entity must be allocated between the goods or services sold and the customer loyalty awards redeemable in the future.

- The fair value of each performance obligation on a stand-alone basis shall use for allocation.

- The redeemable customer loyalty awards are initially recognized as a liability and recognized only as a revenue upon redemption.

- If the awards is supplied by a third party, the amount received as consideration for the goods or services sold is recognized in full as revenue. An expense is recognized for the point granted to the customers.

Illustrative Problem:
Customer loyalty awards (awards supplied by the entity)

ABC Corporation grants 1 point for every P 50 sale to its customers. Each point is equivalent to P1. Accumulated points by customers may be used to settle partly or in full any merchandise purchased. During year 2019, total sales of the company amounted to P 50,000,000. Fair values of the merchandise sold and the reward points for the year were P 35,000,000 and P 15,000,000, respectively.

To allocate the transaction price:

TRANSACTION PRICE P 50,000,000

Sales
P 50,000,000 X $\frac{35,000,000}{50,000,000}$ = **35,000,000**

Liability for Customer Loyalty Awards
P 50,000,000 X $\frac{15,000,000}{50,000,000}$ = **15,000,000**

The entry to record the sale of the product would be:

Cash	50,000,000	
Sales		35,000,000
Liability for Customer Loyalty Awards		15,000,000

If at the end of 2019, 60% of the points have been redeemed out of the expected 90% of the points granted to customers will be redeemed, ABC Company will record the recognition of a revenue pertaining to the points redeemed as follows:

Liability for Customer Loyalty Awards	666,666.67	
Sales		666,666.67

1,000,000 points X 60%/90% = 666,666.67

If at the end of 2020, an additional 30% of the points have been redeemed out of the revised expected 95% of the points granted to customers will be redeemed, ABC Company will record the recognition of a revenue pertaining to the points redeemed as follows:

Liability for Customer Loyalty Awards	280,701.75	
Sales		280,701.75

1,000,000 points X (60%+30%) /95% = 947,368.42 – 666,666.67 = 280,701.75

If at the end of 2021, remaining points were all redeemed, the entry would be:

Liability for Customer Loyalty Awards	52,631.58	
Sales		52,631.58

1,000,000 - 947,368.42 = 52,631.58

Illustrative Problem:
Customer loyalty awards (awards supplied by third party)

Assume that DEF Corporation participates in a customer loyalty program operated by ABC Corporation where in it grants 1 point for every P 100 spent on its products. Accumulated points by customers from DEF Corp may be used to settle partly or in full any merchandise purchased from ABC Corporation. DEF Corporation pays ABC P 1 for each point redeemed. During year 2019, total sales of the DEF company amounted to P 25,000,000 and only 45% of the 100% expected total points granted to be redeemed were redeemed by the customers from ABC Corporation which was used to fully settle the purchased of goods.

In the books of DEF and ABC Corporation, the following are the entries:

DEF Corporation			ABC Corporation		
Cash	25,000,000		No entry		
Sales		25,000,000			
Premium Expense	112,500		Accounts Receivable - DEF	112,500	
Payable to ABC		112,500	Sales		112,500
250,000 points x 45%/100% x P1 = 112,500					
Premium Expense	137,500		No entry		
Premium claims outstanding		137,500			
250,000 – 112,500 = 137,500					

UNEARNED REVENUES

- Under IFRS 15, Revenues from contracts with customers is recognized by following the 5- step model:
  Step 1: Identifying the contract with a customer.
  Step 2: Identifying the performance obligations.
  Step 3: Determining the transaction price
  Step 4: Allocating the transaction price to the performance obligations.
  Step 5: Recognizing revenue when the entity satisfies the performance obligations.

- Unearned revenues are amounts collected in advance that not yet earned and recorded as revenues only when the performance obligations are already satisfied. Examples are collections in advance for magazine subscriptions, tickets, gift certificates, etc.

Illustrative Problem:
Unearned revenues (gift certificates outstanding)

ABC Company sells gift certificates in denomination of P 100 only. For the year 2019, 5,000 of P 100 gift certificates were issued to its customers. Out of the 5,000 gift certificates issued 1,000 was related to entity's promotional activities and the remaining were sold to customers. Total cash received related to sales with promotional activities was P 500,000 including the gift certificates which are valued at P 90,000. During the year, gift certificates valued at P250,000 were redeemed and P 40,000 gift certificates have expired.

Entries in the books of ABC would be as follows:

Cash	500,000	
Sales		410,000
Unearned Revenue for Gift Certificates outstanding		90,000
Cash	400,000	
Unearned Revenue for Gift Certificates outstanding		400,000
4,000 gift certificates x P 100 = 400,000		
Unearned Revenue for Gift Certificates outstanding	250,000	
Sales		250,000
Unearned Revenue for Gift Certificates outstanding	40,000	
Gain from Forfeited Gift certificates		40,000

In the statement of financial position as of the end of the year, the balance of Unearned Revenue for Gift Certificates Outstanding under the current liabilities is reported at P200,000.

DEPOSITS AND ADVANCES

- Consist of cash or property received which are returnable to the depositor or accumulated for the purpose of being remitted to third parties (funds held for others).
- If the deposit or advance originates from the company's operating activities, the liability is reported as current.
- If the deposit or advance comes from non-trade activities and is expected to be refunded or paid after more than one year, the liability is reported as non-current.

Illustrative Problem:
Deposits & advances

Citea Company sells 1-liter Citea Milktea for P250 each wherein additional P15 is charged for deposits on bottles to be returned within 15 days from the date of sale. At the start of the year, the balance of Deposits for Returnable Bottles is P125,000. During the year, 5,000 bottles were sold, and deposits received was P75,000. Deposits of P50,000 was refunded and Deposits of P25,000 was forfeited for the bottles not returned within 15 days. The related cost and accumulated depreciation of the bottles not returned within 15 days were P50,000 and P30,000, respectively.

Entries in the books of ABC would be as follows:

Cash	75,000	
Deposits for Returnable Bottles		75,000
Deposits for Returnable Bottles	50,000	
Cash		50,000
Deposits for Returnable Bottles	25,000	
Accumulated Depreciation- Returnable bottles	30,000	
Returnable Bottles		50,000
Gain on Sale of Returnable Bottles		5,000

In the statement of financial position as of the end of the year, the balance of Deposits for Returnable Bottles under the current liabilities is reported at P125,000.

ACCRUED LIABILITIES

- Consists of obligations for expenses incurred on or before the end of the reporting period but payable at a later date.
- Accrued liabilities are recognized by debiting an expense and crediting an accrued liability account.
  Examples: Accrued salaries, accrued interests, accrued rentals, accrued taxes, etc.

BONUS OBLIGATIONS

- Bonus is an additional compensation and incentive given to officers and employees for superior earnings realized during a given year. This is reported as an operating expense and a liability, until it is actually paid. Bonus is recorded by debiting Bonus Expense and crediting Bonus payable.

- Bonus is computed under different variations and is usually expressed as percentage of:

1.) Profit before both bonus and income tax
2.) Profit after bonus but before income tax
3.) Profit after income tax but before bonus
4.) Profit after both bonus and income tax

TAXES & OTHER EMPLOYEE RELATED LIABILITIES

VAT (Value added tax)

- Levied on the sale of goods and services,
- VAT is chargeable to customers which is collected by the seller and to be remitted, on a monthly basis to Bureau Internal Revenue (BIR).
- This VAT payable is reported as part of the current liabilities until it is remitted to BIR.

PAYROLL TAXES

- Employers are required by law to withhold from its employee's salary an amount to SSS, PAG-IBIG and PHILHEALTH equivalent to employee's contribution and also their income taxes. These amounts withheld are reported under the current liabilities until remitted to the appropriate organizations.

Illustrative Problem:

Bonus obligations

ABC Corporation has a profit before bonus and income tax of P 1,000,000 for the year 2019. Bonus rate is 20% and income tax rate is 30%. Compute the bonus and income tax under each different scenario:

1. Bonus is based on profit before bonus and income tax.

   Bonus = 20% (Profit before bonus and income tax)
   = 20% (1,000,000)
   = P 200,000

   Income Tax = 30% (Profit after bonus)
   = 30% (1,000,000 -200,000)
   = P 240,000

2. Bonus is based on profit after bonus but before income tax.

   Bonus = 20% (Profit after bonus)
   = 20% (1,000,000 - B)
   = 200,000 – 0.20B
   = 200,000/1.20
   = P 166,666.67

   Income Tax = 30% (Profit after bonus)
   = 30% (1,000,000 -166,666.67)
   = P 250,000

3. Bonus is based on profit before bonus but after income tax.

Bonus (B)	= 20% (Profit before bonus but after income tax)
B	= 20% (1,000,000- T)
B	= 20% (1,000,000- (300,000– 0.30B))
B	= 200,000 – 60,000 + 0.06B
B	= 140,000/0.96
B	= P 145,833.33

Income Tax (T)	= 30% (Profit after bonus)
T	= 30% (1,000,000 – 145,833.33)
T	= P 256,250

4. Bonus is based on profit after bonus and income tax.

Bonus	= 20% (Profit after bonus and income tax)
B	= 20% (1,000,000 – B - T)
B	= 20% (1,000,000 – B – 300,000 + 0.30B)
B	= 20% (700,000 – 0.70B)
B	= 140,000 – 0.14B
B	= 140,000/1.14
B	= P 122,807.02

Income Tax (T)	= 30% (Profit after bonus)
T	= 30% (1,000,000 –122,807.02)
	= P 263,157.90

DIVIDENDS PAYABLE

- Dividends can be distributed in different forms.

- Cash dividends payable are dividends recognized at the date of declaration of Board of Directors which are to be distributed in the form of cash at the date of distribution. Normally, cash dividends payable same with property dividends payable and scrip dividends payable are presented under the current liabilities portion because they are usually payable within a short period of time.

- Undeclared cash dividends on cumulative preference shares are not recognized as liabilities but rather they are just disclosed in the notes to financial statements.
- Share dividends distributable is not classified as a liability but rather recognized as part of equity.

SHORT TERM OBLIGATIONS EXPECTED TO BE REFINANCED

- Long term obligations maturing within 12 months from the end of reporting period are generally classified as current liabilities. However, these liabilities may be expected to be refinanced or rolled over at the discretion of the enterprise.

- These obligations are excluded from current liabilities if
    1. The enterprise has the right to defer settlement of the obligation for a period of more than 12 months from the end of the reporting period; or
    2. The agreement to refinance is completed on or before the end of the reporting period; or

3. The enterprise expects and has the discretion to refinance or roll over an obligation under an existing loan facility; or
4. The lender agreed by the end of the reporting period to provide a grace period ending at least 12 months after the end of the reporting period, within which the enterprise can rectify the breach and during which the lender cannot demand immediate payment.

ASSESSMENT ACTIVITIES

PROBLEMS
Show your complete solution, in good accounting form, on a separate sheet of paper.

Problem 1
On November 5, 2019, Kim Joo Meok Truck Rental Company was in an accident with an automobile driven by Pyo ChiSu. Kim Joo Meok Truck received notice on January 12, 2020 of a lawsuit for P700,000 damages for personal injuries suffered by Pyo Chi-Su. Kim Joo Meok Truck's counsel believes it is probable that Pyo Chi-Su will be awarded an estimated amount in the range between P200,000 and P450,000 and that P300,000 is a best estimate of potential liability. Kim Joo Meok Truck's accounting year ends on December 31 and the 2019 financial statements were issued on March 2, 2020.

What amount of loss should Kim Joo Meok Truck Rental Company accrue on December 31, 2019?

Problem 2
Butterfly Corporation started its business in 2019. It sells printers with a 3-year warranty. Butterfly corporation estimates its warranty cost as a percentage of peso sales. Based on past experience, it is estimated that 2% will be repaired during the first year of warranty, 4% will be repaired during the second year of warranty and 6% will be repaired in the third year.

In 2019 and 2020, the company was able to sell 7,500 units and 8,400 units, respectively at a selling price of P 5,000 per unit. The company also incurred actual repair costs of P 530,000 and P 1,176,000 in 2019 and 2020, respectively.

What amount should Butterfly Corporation report as warranty expense in 2019?
What is the amount of liability for warranty reported in Butterfly corporation's December 31,2020 Statement of Financial Position?

Problem 3
The Ri Jung Hyuk Company sold 1,500,000 boxes of cake mix during the year under a new sales promotion program. Each box contains one coupon that, submitted with P40.00 entitles the customer to a baking pan. The Ri Jung Hyuk pays P50.00 per pan. The entity treated the premiums as selling expense. The company estimates that 80% of the coupons will be redeemed even though only 900,000 coupons had been processed during the year.

What amount should Ri Jung Hyuk report as a liability for unredeemed coupons at year end?

Problem 4

Moon Mang-tae Company launched a sales promotional program wherein for every 10 used ballpens purchased are returned, customers will receive a correction tape. This correction tape is separately sold at P 75. Mang-tae estimates that 20% of the ballpens reaching the customers will not be redeemed. Additional information are as follows:

	Units	Amount
Sale of ballpens	500,000	25,000,000
Purchase price of correction tape	55,000	3,575,000
Correction tape distributed to customers	30,000	

In accordance with IFRS 15, how much is the balance of Unearned Revenue for Premium Claims at the end of the year?

Problem 5

Seo Dan Department Store sells gift certificates that are redeemable only when the merchandise is purchased from its stores. It is the company's policy to recognize the amount redeemed as realized. During 2019, Seo Dan Department Store sold gift certificates amounting to P1,800,000 and redeemed gift certificates worth P1,560,000. Gift certificates outstanding on January 1, 2019 is P520,000. The company's gross profit rate is 40%.

What is the liability for outstanding gift certificates on December 31, 2019?

Problem 6

DanBam sells its products in reusable expensive containers. The customer is charged a deposit for each container delivered and receives a refund for each container returned within 2 years after the delivery. Danbam accounts for any container not returned within 2 years as being retired by sale at the deposit amount. Information relating to customer deposits follows:

Containers held by customers at December 31,2018 from deliveries in	
2017	P 75,000
2018	215,000
Containers delivered in 2019	390,000
Containers returned in 2019 from deliveries in	
2017	P 45,000
2019	125,000
2019	143,000

What amount should DanBam report as a liability for deposits on returnable containers on December 31, 2019?

Problem 7

ABC Department store grants loyalty awards to its customers wherein for every P100 purchase made, the customer receives 5 points equivalent to P5. The points accumulated by the customer may be used as part or full payment for merchandise purchases in the future. During 2018, total sales amounted to P10,000,000. Fair values of the merchandise sold, and reward points are P9,500,000 and P500,000, respectively. At the end 2018, 60% out of 90% have been redeemed by the customers. At the end 2019, an additional 20% have been redeemed and the revised estimate of total points expected to be redeemed was now at 95%.

In accordance with IFRS 15, how much revenue was recognized for the year 2019 related to loyalty awards redeemed by the customers?

Problem 8
Park Kwang-beom, Inc. (TCI) is a dealer of Ikea trucks and automobiles. TCI distributes annual bonuses to its Vice President for Sales and three division managers, namely: Truck Division, SUV Division and AUV and Sean Division. The company reported P12,000,000 profit for 2019 before bonuses and income tax. Income tax rate is 30%.

How much should the vice president and each division manager receive, respectfully, if the vice president gets 3% and each division manager gets 1% of profit after bonuses but before income taxes?

Problem 9
During 2020, Jjajangmyeon Company became involved in a tax dispute with the BIR. On December 31, 2020, Jjajangmyeon's tax advisor believed that an unfavorable outcome was probable, and a reasonable estimate of additional taxes was P5,000,000. After the 2020 financial statements were issued, Jjajangmyeon received and accepted a BIR settlement of P5,500,000.

What amount of accrued liability would Jjajangmyeon have reported on its December 31, 2020 balance sheet?

Problem 10
AVC Company started its business in 2019. It sells an equipment with a 3- year warranty. AVC estimates its warranty costs as a percentage of peso sales. Based on past experience, it is estimated that 4% will be repaired in the first year of warranty, 8% on the second year of warranty and 10% at the last year of warranty period. In 2019, 2020 and 2021, the company was able to sell 10,000 units, 12,000 units and 15,000 units, respectively at a selling price of P 7,500 per unit. The company also incurred actual repair costs of P 500,000, P 1,000,000, and 1,500,000 for years 2019, 2020 and 2021, respectively.

What amount should AVC Company report as warranty expense for year 2020 and warranty liability as of December 31, 2020, respectively?

Module 3
LEASES

Overview:

IFRS 16 *Leases* was issued by the IASB in January 2016. It replaced IAS 17 Leases for the reporting periods beginning on or after January 1, 2019. This module discusses leases in the context of IFRS 16 which sets out the principles for the recognition, measurement, presentation, and disclosure of leases. The objective is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance, and cash flows of an entity.

Module Objectives:

After reading this module, you should be able to:

- describe the nature of leases and determine whether a contract contains a lease based on IFRS 16;
- describe the accounting criteria and procedures for capitalizing leases by the lessee;
- describe the accounting criteria and procedures for recognition exception for accounting the lease by the lessee;
- formulate entries relating to lease in the books of the lessee;
- comprehend the accounting criteria and procedures for identifying operating and finance lease by the lessor;
- analyze the criteria how the lessor recognizes finance lease under direct finance or manufacturer's/dealer's lease;
- formulate entries relating to lease in the books of the lessor;
- present information arising from leasing transactions on the face of the financial statements;
- account for sale and leaseback transactions; and
- identify the required disclosures in the financial statements of the lessor and the lessee.

NATURE OF LEASES

Lease is a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

Identifying a Lease

A contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Control is conveyed where the customer has both the right to direct the identified asset's use and to obtain substantially all the economic benefits from that use. However, where a supplier has a substantive right of substitution throughout the period of use, a customer does not have a right to use an identified asset. A supplier's right of substitution is only considered substantive if the supplier has both the practical ability to substitute alternative assets throughout the period of use and they would economically benefit from substitution. A capacity portion of an asset is still an identified asset if it is physically distinct (e.g., a floor of a building). A capacity or other portion of an asset that is not physically distinct (e.g., a capacity portion of a fiber optic cable) is not an identified asset, unless it represents

substantially all the capacity such that the customer obtains substantially all the economic benefits from using the asset.

Separating components of a contract

For a contract that contains a lease component and additional lease and non-lease components, such as the lease of an asset and the provision of a maintenance service, lessees shall allocate the consideration payable on the basis of the relative stand-alone prices, which shall be estimated if observable prices are not readily available. As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components and instead account for all components as a lease.

Definition of Terms

- Commencement date of the lease (commencement date) - The date on which a lessor makes an underlying asset available for use by a lessee.
- Economic life - Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.
- Finance lease - A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset.
- Fixed payments - Payments made by a lessee to a lessor for the right to use an underlying asset during the lease term, excluding variable lease payments.
- Gross investment in the lease - The sum of: (a) the lease payments receivable by a lessor under a finance lease; and (b) any unguaranteed residual value accruing to the lessor.
- Inception date of the lease (inception date) - The earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.
- Initial direct costs - Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.
- Interest rate implicit in the lease - The rate of interest that causes the present value of
    - (a) the lease payments and
    - (b) the unguaranteed residual value to equal the sum of
        - (i) the fair value of the underlying asset and
        - (ii) any initial direct costs of the lessor.
- Lease - A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.
- Lease incentives - Payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee.
- Lease modification - A change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease.
- Lease payments - Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:
    - fixed payments (including in-substance fixed payments), less any lease incentives;
    - variable lease payments that depend on an index or a rate;
    - the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
    - payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.
- Lease term - The non-cancellable period for which a lessee has the right to use an underlying asset, together with both: (a) periods covered by an option to extend the lease

if the lessee is reasonably certain to exercise that option; and (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

- Lessee - An entity that obtains the right to use an underlying asset for a period of time in exchange for consideration.
- Lessee's incremental borrowing rate - The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.
- Lessor - An entity that provides the right to use an underlying asset for a period of time in exchange for consideration.
- Net investment in the lease - The gross investment in the lease discounted at the interest rate implicit in the lease.
- Operating lease - A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.
- Optional lease payments - Payments to be made by a lessee to a lessor for the right to use an underlying asset during periods covered by an option to extend or terminate a lease that are not included in the lease term.
- Residual value guarantee - A guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease will be at least a specified amount.
- Right-of-use asset - An asset that represents a lessee's right to use an underlying asset for the lease term.
- Short-term lease - A lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.
- Sublease - A transaction for which an underlying asset is re-leased by a lessee ('intermediate lessor') to a third party, and the lease ('head lease') between the head lessor and lessee remains in effect.
- Underlying asset - An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.
- Unearned finance income - The difference between (a) the gross investment in the lease; and (b) the net investment in the lease.
- Unguaranteed residual value - That portion of the residual value of the underlying asset, the realization of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.
- Variable lease payments - The portion of payments made by a lessee to a lessor for the right to use an underlying asset during the lease term that varies because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.

ACCOUNTING BY THE LESSEE

Initial Recognition

Upon lease commencement a lessee recognizes a right-of-use asset and a lease liability. The right-of-use asset is initially measured at the amount of the lease liability plus any initial direct costs incurred by the lessee. Adjustments may also be required for lease incentives, payments at or prior to commencement and restoration obligations or similar items. The lease liability is initially measured at the present value of the lease payments payable over the lease term, discounted at the rate implicit in the lease if that can be readily determined. If that rate cannot be readily determined, the lessee shall use their incremental borrowing rate.

At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:

a. Fixed payments, less any lease incentives receivable
b. Variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date
c. Amounts expected to be payable by the lessee under residual value guarantees.
d. The exercise price of a purchase option if the lessee is reasonably certain to exercise that option
e. Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

The journal entry to record at the commencement of the lease to recognize the right-of-use asset and lease liability is as follows:

Right-of-use asset	XX	
Cash		XX
Lease liability		XX
Provision for restoration/dismantling/decommissioning		XX

Subsequent Measurement of Right-of-Use Asset

After lease commencement, a lessee shall measure the right-of-use asset using a cost model, unless:

- ❖ The right-of-use asset is an investment property and the lessee fair values its investment property under IAS 40; or
- ❖ The right-of-use asset relates to a class of PPE to which the lessee applies IAS 16's revaluation model.

Under the cost model a right-of-use asset is measured at cost less accumulated depreciation and accumulated impairment. A lessee shall apply the depreciation requirements in IAS 16 *Property, Plant and Equipment* in depreciating the right-of-use asset. If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term or if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option, the lessee shall depreciate the right-of-use asset from the commencement date to the end of the useful life of the underlying asset. Otherwise, the lessee shall depreciate the right-of-use asset from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. The journal entry to record the depreciation is

Depreciation expense	XX	
Accumulated Depreciation		XX

If a lessee applies the fair value model in IAS 40 *Investment Property* to its investment property, the lessee shall also apply that fair value model to right-of-use assets that meet the definition of investment property in IAS 40.

If right-of-use assets relate to a class of property, plant, and equipment to which the lessee applies the revaluation model in IAS 16, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant, and equipment.

Subsequent Measurement of Lease Liability

After the commencement date, a lessee shall measure the lease liability by:

(a) increasing the carrying amount to reflect interest on the lease liability;

(b) reducing the carrying amount to reflect the lease payments made; and

(c) remeasuring the carrying amount to reflect any reassessment or lease modifications specified

Interest on the lease liability in each period during the lease term shall be the amount that produces a constant periodic rate of interest on the remaining balance of the lease liability.

Variable lease payments that are not included in the measurement of the lease liability are recognized in profit or loss in the period in which the event or condition that triggers payment occurs unless the costs are included in the carrying amount of another asset under another standard. On the other hand, the lease liability is subsequently remeasured to reflect changes in:

a. The lease term (using a revised discount rate)
b. The assessment of a purchase option (using a revised discount rate)
c. The amounts expected to be payable under residual value guarantees (using an unchanged discount rate); or
d. Future lease payments resulting from a change in an index or a rate used to determine those payments (using an unchanged discount rate).

The remeasurements are treated as adjustments to the right-of-use asset. Lease modifications may also prompt remeasurement of the lease liability unless they are to be treated as separate leases.

Presentation in the Financial Statements

A lessee shall either present in the statement of financial position or disclose in the notes to the financial statements:

(a) right-of-use assets separately from other assets. If a lessee does not present right-of-use assets separately in the statement of financial position, the lessee shall:

- include right-of-use assets within the same line item as that within which the corresponding underlying assets would be presented if they were owned; and
- disclose which line items in the statement of financial position include those right-of-use assets.

(b) lease liabilities separately from other liabilities. If the lessee does not present lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those liabilities.

For the assets classified under IAS 40, they shall be presented in the statement of financial position as investment property.

In the statement of profit or loss and other comprehensive income, a lessee shall present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset. Interest expense on the lease liability is a component of finance costs, which in IAS 1 Presentation of Financial Statements requires to be presented separately in the statement of profit or loss and other comprehensive income.

In the statement of cash flows, a lessee shall classify the cash payments for the principal portion of the lease liability within financing activities, cash payments for the interest portion of the lease liability applying the requirements in IAS 7 *Statement of Cash Flows* for interest paid and short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities.

Recognition Exemption

Instead of applying the recognition requirements of IFRS 16 described above, a lessee may elect to account for lease payments as an expense on a straight-line basis over the lease term or another systematic basis for the following two types of leases:

a. Leases with a lease term of 12 months or less and containing no purchase options – this election is made by class of underlying asset
b. Leases where the underlying asset has a low value when new (such as personal computers or small items of office furniture) – this election can be made on a lease-by-lease basis.

The election for short-term leases shall be made by class of underlying asset to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations. The election for leases for which the underlying asset is of low value can be made on a lease-by-lease basis.

ACCOUNTING BY THE LESSOR

A lessor shall classify each lease as an operating lease or a finance lease. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

- ❖ The lease transfers ownership of the asset to the lessee by the end of the lease term.
- ❖ The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised.
- ❖ The lease term is for the major part of the economic life of the asset, even if title is not transferred.
- ❖ At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.
- ❖ The leased assets are of a specialized nature such that only the lessee can use them without major modifications being made.

Operating Lease

A lessor shall recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

A lessor shall add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset and recognise those costs as an expense over the lease term on the same basis as the lease income.

A lessor shall recognise costs, including depreciation, incurred in earning the lease income as an expense. The depreciation policy for depreciable underlying assets subject to operating leases shall be consistent with the lessor's normal depreciation policy for similar assets. A lessor shall calculate depreciation in accordance with IAS 16 and IAS 38.

A lessor shall present underlying assets subject to operating leases in its statement of financial position according to the nature of the underlying asset.

Finance Lease

At the commencement date, a lessor shall recognise assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the net investment in the lease.

The lessor shall use the interest rate implicit in the lease to measure the net investment in the lease. In the case of a sublease, if the interest rate implicit in the sublease cannot be readily determined, an intermediate lessor may use the discount rate used for the head lease (adjusted for any initial direct costs associated with the sublease) to measure the net investment in the sublease.

Initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognized over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease; there is no need to add them separately.

The lease payments included in the measurement of the net investment in the lease comprise the following payments for the right to use the underlying asset during the lease term that are not received at the commencement date:

a. fixed payments (including in-substance fixed payments) less any lease incentives payable
b. variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date
c. any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee
d. the exercise price of a purchase option if the lessee is reasonably certain to exercise that option
e. payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Direct Financing Lease

In the direct finance lease, the lessor is usually a financing company that purchase assets specifically for lease. In this scenario, the cost of the leased asset is equal to its fair market value. Thus, the lessor recognizes only one type of revenue and that is, interest revenue and no gross profit is recognized.

The total interest revenue is equal to the excess of the gross investment/receivable over the fair market value (or cost) of the leased property and should be amortized as interest revenue over the term of the lease using interest method. Any executory costs are charged to expense when incurred. At the commencement date of the lease, the lessor records the following entry:

Cash	XX	
Finance Lease Receivable	XX	
Leased Asset		XX
Unearned finance income		XX

Moreover, initial direct costs are added to the net investment in the lease and amortized over the life of the lease as a yield adjustment (reduction from interest revenue). The entry for the payment of initial direct cost is:

Unearned finance income	XX	
Cash		XX

Manufacturer/ Dealer's Lease

This was previously referred to as sales-type lease. The lessor is a manufacturer or dealer that uses lease as a means of selling its products. In this case, the cost of the asset is not equal to its fair market value. The lessor records the lease as a sale of property on a deferred payment contract.

At the commencement date, a manufacturer or dealer lessor shall recognise the following for each of its finance leases:

- revenue being the fair value of the underlying asset, or, if lower, the present value of the lease payments accruing to the lessor, discounted using a market rate of interest
- the cost of sale being the cost, or carrying amount if different, of the underlying asset less the present value of the unguaranteed residual value
- selling profit or loss (being the difference between revenue and the cost of sale) in accordance with its policy for outright sales to which IFRS 15 applies.

A manufacturer or dealer lessor shall recognise selling profit or loss on a finance lease at the commencement date, regardless of whether the lessor transfers the underlying asset as described in IFRS 15.

A manufacturer or dealer lessor shall recognise as an expense costs incurred in connection with obtaining a finance lease at the commencement date because they are mainly related to earning the manufacturer or dealer's selling profit. Costs incurred by manufacturer or dealer lessors in connection with obtaining a finance lease are excluded from the definition of initial direct costs and, thus, are excluded from the net investment in the lease and recorded as expense. Moreover, any executory costs are charged to expense when incurred.

The gross amount of the bargain purchase option (BPO) and the residual value, whether guaranteed or unguaranteed, are added to the receivable account (or gross investment). However, the present value of the BPO or guaranteed residual value (GRV) is added to sales and the difference between the gross amount and the present value is added to unearned interest revenue. On the contrary, when the residual value is not guaranteed (URV) by the lessee, the present value is deducted from cost of sales. The pro-forma entry at the commencement of the lease term are as follows:

Cash	XX	
Finance Lease Receivable (gross lease collection + GRV/URV/BPO)	XX	
Sales (Fair value or PV of Finance Lease receivable+ PV of BPO/GRV)		XX
Unearned Interest Revenue		XX

Cash	XX	
Finance Lease Receivable (gross lease collection + GRV/URV/BPO)	XX	
Sales (Fair value or PV of Finance Lease receivable+ PV of BPO/GRV)		XX
Unearned Interest Revenue		XX

Subsequent Measurement

A lessor shall recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease. A lessor aims to allocate finance income over the lease term on a systematic and rational basis. A lessor shall apply the lease payments relating to the period against the gross investment in the lease to reduce both the principal and the unearned finance income.

The entries for the subsequent collection of rentals are the same under both direct financing lease and manufacturer's lease.

Cash	XX	
Finance Lease Receivable		XX

On the other hand, the entry to record the amortization of unearned interest revenue is

Unearned interest revenue	XX	
Interest revenue		XX

SALE AND LEASEBACK TRANSACTIONS

If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor shall account for the transfer contract. An entity shall apply the requirements for determining when a performance obligation is satisfied in IFRS 15 to determine whether the transfer of an asset is accounted for as a sale of that asset.

Transfer of the asset is a sale

If the transfer of an asset by the seller-lessee satisfies the requirements of IFRS 15 to be accounted for as a sale of the asset:

(a) the seller-lessee shall measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use

retained by the seller-lessee. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.

(b) the buyer-lessor shall account for the purchase of the asset applying applicable standards, and for the lease applying the lessor accounting requirements in this standard.

If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the payments for the lease are not at market rates, an entity shall make the following adjustments to measure the sale proceeds at fair value, any below-market terms shall be accounted for as a prepayment of lease payments, and any above-market terms shall be accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

The entity shall measure any potential adjustment on the basis of the more readily determinable of the difference between the fair value of the consideration for the sale and the fair value of the asset and the difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates.

Transfer of the asset is not a sale

If the transfer of an asset by the seller-lessee does not satisfy the requirements of IFRS 15 to be accounted for as a sale of the asset, the seller-lessee shall continue to recognise the transferred asset and shall recognise a financial liability equal to the transfer proceeds. It shall account for the financial liability applying IFRS 9.

Moreover, the buyer-lessor shall not recognise the transferred asset and shall recognise a financial asset equal to the transfer proceeds. It shall account for the financial asset applying IFRS 9.

ASSESSMENT ACTIVITIES

DISCUSSION QUESTIONS

In a separate sheet of paper, kindly copy the questions, then answer.

1. One of the advantages of leasing rather than purchasing an asset is that leasing offers flexibility and a lower cost when disposing of the asset. Explain.
2. The basic concept of “substance over form” influences lease accounting. Explain.
3. How is interest expense determined in a finance lease transaction? How does the approach compare to other forms of debt (such as bonds payable or notes payable)?
4. How are leases and installment notes the same? How do they differ?
5. A lessee should classify a lease transaction as a finance lease if it is noncancelable and one or more of five classification criteria are met. Otherwise, it is an operating lease. What are these criteria?
6. BTS Industries leased non-specialized equipment to BigHit Corporation for a four-year period, at which time possession of the leased asset will revert back to BTS. The equipment cost BTS P4,000,000 and has an expected useful life of six years. Its normal sales price is P5,600,000. The present value of the lease payments for both the lessor and lessee is P5,200,000. The first payment was made at the beginning of the lease. How should this lease be classified (a) by BTS Industries (the lessor) and (b) by BigHit Corporation (the lessee)? Why?
7. In accounting for a finance lease/sales-type lease, how are the lessee’s and lessor’s income statements affected?
8. What is selling profit on a sales-type lease? How do we account for a sales-type lease with a selling profit?
9. At the beginning of an operating lease, the lessee will record what asset and liability, if any?
10. At the beginning of an operating lease, the lessor will record what asset or assets, if any?

11. In accounting for an operating lease, how are the lessee's and lessor's income statements affected? Briefly describe the conceptual basis for asset and liability recognition under the right-of-use approach used by the lessee in a lease transaction.
12. In a financing lease, "front loading" of lease expense and lease revenue occurs. What does this mean, and how is it avoided in an operating lease?
13. The discount rate influences virtually every amount reported in connection with a lease by both the lessor and the lessee. What is the lessor's discount rate when determining the present value of lease payments? What is the lessee's discount rate?
14. A lease that has a lease term (including any options to terminate or renew that are reasonably certain) of twelve months or less is considered a "short-term lease." How does a lessee record a lease using the shortcut approach available as an option for short-term leases?
15. A lease might specify that lease payments may be increased (or decreased) at some future time during the lease term depending on whether or not some specified event occurs such as revenues or profits exceeding some designated level. Under what circumstances are contingent rentals included or excluded from lease payments? If excluded, how are they recognized in income determination?
16. What is a purchase option? How does it affect accounting for a lease?
17. A six-year lease can be renewed for two additional three-year periods, and it also can be terminated after only three years. How do the lessee and lessor decide the lease term to be used in accounting for the lease?
18. BT21 Creations leased kitchen equipment under a five-year lease with an option to renew for three years at the end of five years and an option to renew for an additional three years at the end of eight years. The first three-year renewal option can be exercised for one-half the original and usual rate. What is the length of the lease term that BT21 Creations should assume in recording the transactions related to the lease?
19. What situations cause us to remeasure a lease liability and right-of-use asset? How is that accomplished?
20. Occasionally, a lease agreement includes a guarantee by the lessee that the lessor will recover a specified residual value when custody of the asset reverts back to the lessor at the end of the lease term. Under what circumstance can the guaranteed residual value influence the amounts recorded by the lessee and lessor? In that circumstance, how are the amounts affected?
21. Compare the way a purchase option that is reasonably certain to be exercised and a lessee-guaranteed residual value are treated by the lessee and lessor when determining lease payments. What non-lease costs might be included as part of lease payments? How are they accounted for by the lessee in a finance lease when paid by the lessee? When paid by the lessor? Explain.
22. The lessor's initial direct costs often are substantial. What are initial direct costs?
23. When are initial direct costs recognized in an operating lease? In a sales-type lease with selling profit? In a sales-type lease with no selling profit? Why?
24. What is the primary objective of the required lease disclosures for the lessor and lessee?
25. When a company sells an asset and simultaneously leases it back, what criteria must be met to apply sale-leaseback accounting rather than accounting for the transaction as a loan?
26. Jungkook Machines sold equipment with a 10-year economic life to Taehyung Acres, while concurrently entering into an 8-year leaseback. Eight years is considered a major part of the economic life of the equipment. The sale agreement contains no option for Jungkook to repurchase the equipment or any other provision that would prevent its sale. Can Jungkook Machines account for the transaction as a sale-leaseback? Why?

PROBLEMS
Show your complete solution, in good accounting form, on a separate sheet of paper. (Note: Please always use four-decimal places for the PV factors)

Problem 1
On January 1, 2020, Euphoria Corporation signed a 5-year noncancelable lease for a machine. The terms of the lease called for Euphoria to make annual payments of P80,668 at the beginning of each year, starting January 1, 2020. The machine has an estimated useful life of 6 years and a P50,000 unguaranteed residual value. The machine reverts back to the lessor at the end of the lease term. Euphoria uses the straight-line method of depreciation for all of its plant assets. Euphoria's incremental borrowing rate is 10%, and the lessor's implicit rate is unknown.

Compute the lease liability and right-of-use asset as of January 1, 2020.
Prepare all necessary journal entries for Euphoria for this lease.

Problem 2
Make It Right Company leases an automobile with a fair value of P872,500 from Love Your Self Motors, Inc., on the following terms:

1. Noncancelable term of 50 months.
2. Rental of P20,000 per month (at end of each month).
3. Estimated residual value after 50 months is P118,000. It was guaranteed by Make It Right Company.
4. Estimated economic life of the automobile is 60 months.
5. The implicit rate in the lease is 12% a year (1% a month).

Record the lease on Make It Right Company's books at the date of inception.
Record the first month's depreciation on Make It Right Company's books (assume straight-line).
Record the first month's lease payment.

Problem 3
Assume that on January 1, 2020, Boy With Luv Corp. signs a 10-year noncancelable lease agreement to lease a storage building from Jamias Vu Company. Boy With Luv's corporate year-end is December 31. The following information pertains to this lease agreement.

1. The agreement requires equal rental payments of P72,000 beginning on January 1, 2020.
2. The fair value of the building on January 1, 2020, is P440,000.
3. The building has an estimated economic life of 12 years, with an unguaranteed residual value of P10,000. Boy With Luv depreciates similar buildings on the straight-line method.
4. The lease is nonrenewable. At the termination of the lease, the building reverts to the lessor.
5. Boy With Luv's incremental borrowing rate is 12% per year. The lessor's implicit rate is not known by Boy With Luv.
6. The yearly rental payment includes P2,471 of executory costs related to taxes on the property.

Prepare the journal entries (including the computations) on the lessee's books to reflect the signing of the lease agreement and to record the payments and expenses related for the ten-year lease term.

Problem 4

Dynamite Leasing Company signs a lease agreement on January 1, 2020, to lease electronic equipment to Life Goes On Company. The term of the noncancelable lease is 2 years, and payments are required at the end of each year. The following information relates to this agreement:

1. Life Goes On Company has the option to purchase the equipment for P16,000 upon termination of the lease.
2. The equipment has a cost and fair value of P160,000 to Dynamite Leasing Company. The useful economic life is 2 years, with a salvage value of P16,000.
3. Life Goes On Company is required to pay P5,000 each year to the lessor for executory costs.
4. The implicit rate in the lease is 10%.

Prepare the journal entries on the books of Dynamite Leasing to reflect the payments received under the lease and to recognize income for the years 2020 and 2021.
Assuming that Life Goes On Company exercises its option to purchase the equipment on December 31, 2020, prepare the journal entry to reflect the sale on Dynamite's books.

Problem 5

Lights Leasing Company signs an agreement on January 1, 2020, to lease equipment to Magic Shop Company. Assume the lessor's annual accounting period ends on December 31. The following information relates to this agreement.

1. The term of the noncancelable lease is 6 years with no renewal option. The equipment has an estimated economic life of 6 years.
2. The cost of the asset to the lessor is P245,000. The fair value of the asset on January 1, 2020, is P245,000.
3. The asset will revert to the lessor at the end of the lease term, at which time the asset is expected to have a residual value of P43,622, none of which is guaranteed.
4. Magic Shop Company assumes direct responsibility for all executory costs.
5. The agreement requires equal annual rental payments, beginning on January 1, 2020.
6. The implicit rate in the lease is 10%

Calculate the amount of the annual rental payment required.
Prepare an amortization schedule that would be suitable for the lessor for the lease term.
Prepare all of the journal entries for the lessor for the receipt of lease payments, and the recognition of income.

Problem 6

Burning Up Machineries, dealer of machinery and equipment, leased equipment to Serendipity Products on July 1, 2019. The lease is appropriately accounted for as a sale by Burning Up and as a purchase by Serendipity. The lease is for 10-year period (the useful life of the asset) expiring on July 1, 2029. The first ten equal annual payments of P250,000 was made on July 1, 2019. Burning Up purchased the equipment for P1,337,500 on January 1, 2019 and established a list selling price of P1,687,500 on the equipment. Assume that the present value on July 1, 2019 of the payments over the lease term discounted at 12% was P1,582,500.

Prepare the entries to record up to July 1, 2029.
Determine the balances of the accounts to be reported each year assuming that the calendar year ends on December 31.

Problem 7
On January 1, 2020, Anpanman Co. leased a building to Epiphany Inc. The relevant information related to the lease is as follows.

1. The lease arrangement is for 10 years.
2. The leased building cost P4,500,000 and was purchased for cash on January 1, 2020.
3. The building is depreciated on a straight-line basis. Its estimated economic life is 50 years with no salvage value.
4. Lease payments are P275,000 per year and are made at the end of the year.
5. Property tax expense of P85,000 and insurance expense of P10,000 on the building were incurred by Anpanman in the first year. Payment on these two items was made at the end of the year.
6. Both the lessor and the lessee are on a calendar-year basis.

Prepare the journal entries that Anpanman Co. should make in 2020 and 2021.
If Anpanman paid P30,000 to a real estate broker on January 1, 2020, as a fee for finding the lessee, how much should Anpanman Co. report as an expense for this item in 2020?

Problem 8
On August 1, 2020, Fake Love Co. leased a delivery truck from Home Company under a one-year contract. The lease payments are as follows: First 6 months at P120,000 per month; next 6 months at P80,000 per month.

Prepare the entries in the books of Fake Love.
What is the amount reported in Fake Love's balance sheet on Dec. 31, 2020 as a result of the lease?

Problem 9
On December 31, 2019, Blue & Grey Company sold a machinery with a remaining life of six years for P2,000,000. On the same date, Blue & Grey Company leased back the equipment for three years at the prevailing annual rental of P4800,000. The machine has an original cost of P3,000,000 and an accumulated depreciation of P1,400,000. On the date of sale and leaseback, the machine has a fair value of P1,700,000. Implicit rate is 10%.

How much is the gain as a result of the sale and leaseback transaction?

Problem 10
On January 1, 2020, Telephathy Company sold an equipment with carrying amount of P6,000,000 and a remaining useful life of 10 years to Stigma Drilling Company for P9,000,000. Telephathy Company immediately leased the equipment back under a 10-year finance lease by payment of P1,080,000 starting on December 31, 2019. Rate implicit in the lease on January 1, 2020 is 10%. The asset's fair value at that time was P6,000,000 and will be depreciated using the straight-line method. The transaction meets the criteria of IFRS 15 to be accounted for as sale.

Prepare the entry to record the transaction on January 1, 2020.

Module 4
SHAREHOLDERS' EQUITY

Overview

The Conceptual Framework states a simple definition for equity: "the residual interest in the assets of the entity after deducting all its liabilities". This definition confirms the most basic principle in accounting, which is expressed in the accounting equation: Assets = Liabilities + Equity. IFRS does not have a separate standard devoted to shareholders' equity. However, there are several ways in which the presentation, measurement, and disclosure of equity transactions can be quite complex. Although equity is the residual interest of the business's owners, it is not simply a plug figure used to balance the accounting equation. In this module, we will discuss the accounting for equity transactions, and examine the presentation, measurement, and disclosure requirements.

Module Objectives

At the end of this module, the learner will be able to:

- ❖ distinguish a corporation from the other forms of business organization;
- ❖ identify the different sources of corporate capital;
- ❖ describe the features of the different classes of share capital;
- ❖ record properly subscription to share capital and issuance of share capital;
- ❖ record properly treasury share transactions and retirement of share capital;
- ❖ account for stock rights, share warrants, share options, and share appreciation rights (IFRS 2);
- ❖ identify the factors affecting the retained earnings balance;
- ❖ record properly dividend transactions;
- ❖ allocate cash dividends between preference share and ordinary share;
- ❖ account for quasi-reorganization;
- ❖ compute book value per share; and
- ❖ identify the required disclosures relating to shareholders' equity.

Course Material

NATURE OF CORPORATION

Republic Act 11232 known as the "Revised Corporation Code of the Philippines" defines a corporation as an artificial being created by operation of law, having the right of succession and the powers, attributes, and properties expressly authorized by law or incidental to its existence. The corporation's power of succession enables it to enjoy a continuous existence. Moreover, it enables large scale business undertakings because many individuals can invest their funds in the company. In a corporation, compared with the sole proprietorship and partnership, the liability of its investors or shareholders is limited to the extent of their investment in the corporation.

Sources of Corporate Capital

The funds contributed by shareholders are often the initial capital used to start a business. These funds are known as contributed capital. In a corporate structure, contributed capital will take the form of shares, which can be classified into several different types:

- ❖ **Preference shares or preferred stocks.** These are shares that have special rights and privileges that give them priority over the ordinary shares. These special privileges are often included to make the shares more attractive to investors. In the incident of a business's liquidation after all the debts are paid, the preferred shareholders would rank ahead of the ordinary shareholders in the priority of payment. Moreover, preference

shareholders will receive any dividends first before any distribution to the ordinary shareholders.

- **Ordinary shares or common stocks.** These are shares which represent the final residual interest in a company's assets after all other claims, including other equity interests, have been satisfied. In some companies, these are the only types of shares issued. These shares represent the greatest level of risk to an investor should the company fail, as all other claims against the company's assets would need to be paid first. On the other hand, these shares also represent potentially the greatest rewards, as all the profits not otherwise allocated to debt and equity holders would belong to the common shareholders.

Shares are legal instruments that give certain rights to the holder and signify a residual interest in the corporation's assets. When a corporation is formed, its Articles of Incorporation will specify the maximum number of shares that can be issued. The maximum number of shares is referred to as **authorized shares**. Moreover, **issued shares** are shares that have been issued to shareholders, usually in exchange for money, services, or other assets.

Shares can be issued with a par value. This is the stated value of the share and will be directly indicated on the share certificate. Where par value shares exist, the actual issue price may differ from the par value. Amounts received by the corporation in excess of the par value represent another form of contributed capital. This amount will be reported separately from the par value of the shares and is often described as either share premium, additional paid-in capital or contributed surplus.

Shares of capital stock issued without par value shall be deemed fully paid and nonassessable and the holder of such shares shall not be liable to the corporation or to its creditors. A no-par value share must be issued for a consideration of at least five pesos (P5.00) per share. Provided, further, that the entire consideration received by the corporation for its no par value shares shall be treated as capital and shall not be available for distribution as dividends. (R.A. 11232 section 6)

AUTHORIZATION, ISSUANCE, REACQUISITION AND RETIRMENT OF SHARES

Authorization of Shares

As mentioned earlier, the maximum number of shares that a corporation can issue is known as authorized shares. Corporation cannot issue more than the authorized shares, but it may be increased by amending the articles of incorporation. The authorized share capital can be determined by multiplying the number of authorized shares by the par or stated value of the share capital.

Authorized share capital may be recorded using the journal entry method or the memorandum entry method.

a. **Journal entry method.** Under this method, the entry will be recorded in the general journal and posted to the general ledger. If there will be more than one class of share, there should be separate entry for the share capital and separate ledgers will be maintained. Below is the pro-forma entry using this method:

Unissued Share Capital	XX	
Authorized share capital		XX

b. **Memorandum entry method.** Under this method, only a memorandum entry will be prepared and there is no formal entry made in the journal. This method enjoys popularity in use compared with the journal entry method (Baysa and Lupisan, 2014). Below is a sample memorandum entry:

Memo Entry: Authorized to issue (number of shares authorized) shares of (type of share) share capital with a par value of (value).

Issuance of Shares

Stocks shall not be issued for a consideration less than the par or issued price (R.A. 11232 section 61). These stocks may be issued in exchange for actual cash paid to the corporation, property, tangible or intangible, actually received by the corporation and necessary or convenient for its use and lawful purposes at a fair valuation equal to the par or issued value of the stock issued, labor performed for or services actually rendered to the corporation, previously incurred indebtedness of the corporation and other generally accepted form of consideration. They may also be sold on a subscription basis. Cost related to issuance of shares are deducted from the additional paid-in capital.

a. Issuance in exchange for cash. A share capital can be issued at its par value or above par value. Any excess will be recorded as Share Premium or Paid-in capital in excess of par/ stated value. The pro-forma entry to record the issuance for cash:

Cash (no. of shares x issue price)	XX	
Share Capital (no. of shares x par value)		XX
Share premium		XX

b. Issuance in exchange for non-cash asset. The asset received is to be recorded at its fair value. However, if the fair value of the asset cannot be measured reliably, it should be recorded at the fair value of the shares at the date of issuance and receipt of the asset. The pro-forma entry to record the issuance is:

Non-cash asset	XX	
Share Capital (no. of shares x par value)		XX
Share premium		XX

c. Issuance in exchange for services rendered. When shares are issued in exchange for services rendered, the services received (charged to expense) is recorded at fair value. However, if the fair value of the services cannot be measured reliably, it should be recorded at the fair value of the shares at the date the other party performed the services. The pro-forma entry to record the issuance is:

Expense	XX	
Share Capital (no. of shares x par value)		XX
Share premium		XX

d. Issuance of shares in a subscription basis. Sometimes a corporation may offer shares on a subscription basis, allowing the holder to pay for the shares in a series of payments. The corporation issues the stock certificate to the subscriber upon full payment of the subscription.

The entry to record the receipt of subscription:

Subscription Receivable (no. of shares subscribed x selling price)	XX	
Subscribed Share Capital (no. of shares x par value)		XX
Share premium (no. of shares x [selling price - par value])		XX

The entry to record the collection of subscription:

Cash	XX	
Subscription Receivable		XX

The entry to record issuance of stock certificate upon full payment of subscription:

Subscribed Share Capital	XX	
Share Capital		XX

However, there are cases that the subscribers fail to pay their obligations after the corporation has sent several notices and declare the subscribed shares are delinquent. Unless the delinquent stockholder pays to the corporation, or before the date specified for the sale of the delinquent stock, the balance due on the former's subscription, plus accrued interest, costs of advertisement and expenses of sale, or unless the board of directors otherwise orders, said delinquent stock shall be sold at a public auction to such bidder who shall offer to pay the full amount of the balance on the subscription together with accrued interest, costs of advertisement and expenses of sale, for the smallest number of shares or fraction of a share.

The journal entry to record the subscription default:

Receivable from the Highest Bidder	XX	
Subscription Receivable		XX

The journal entry to record the cost incurred in connection with the delinquency sale:

Receivable from the Highest Bidder	XX	
Cash		XX

The journal entry to record the receipt of payment from the highest bidder:

Cash	XX	
Receivable from the Highest Bidder		XX

The entry to record issuance of stock certificate:

Subscribed Share Capital	XX	
Share Capital		XX

Should there be no bidder at the public auction who offers to pay the full amount of the balance on the subscription together with accrued interest, costs of advertisement, and expenses of sale, for the smallest number of shares or fraction of a share, the corporation may, bid for the same, and the total amount due shall be credited as fully paid in the books of the corporation (R.A. 11232 section 67). The entry to record it are:

Treasury Shares	XX	
Receivable from the Highest Bidder		XX
Subscribed Share Capital	XX	
Share Capital		XX

Reacquisition of Shares

Companies will sometimes reacquire their own shares, often done to try to stabilize their share price or improve their earnings per share. A share may also be repurchased to return excess cash to shareholders without having to pay a dividend. The reacquisition of shares will decrease the number of outstanding shares. Additionally, there may also be certain strategic benefits in repurchasing shares. After repurchasing, the shares may continue to be held by the company as issued shares, which are referred to as treasury shares.

a. Reacquisition by purchase. Treasury shares may be obtained by purchase and the reacquisition will be accounted for the cost method.

The entry to record the reacquisition of shares:

Treasury Shares	XX	
Cash		XX

b. Reacquisition by donation. Shareholders are allowed to donate his shares to the company to enable the company to increase its working capital and at the same time maintain their proportionate ownership interests (Baysa and Lupisan, 2014).

The entry to record the receipt of the donation:

Treasury Shares	XX	
Donated capital*		XX

* should be recorded at the fair value at the date of donation

The entry to record the reissuance at cost:

Cash	XX	
Treasury Shares		XX

The entry to record the reissuance above cost:

Cash	XX	
Treasury Shares		XX
Paid-in capital- Treasury shares		XX

The entry to record the reissuance below cost:

Cash	XX	
Paid-in capital- Treasury shares*	XX	
Retained earnings	XX	
Treasury Shares		XX

*if there is an available balance

Retirement of Shares

Retirement of shares demands for cancellation of the stock certificates and cancellation of all the related share capital account and share premium from the original issuance. The difference between the retirement price of the share and the original issuance price is to be recorded as paid-in capital from the retirement of share capital and not to be reported as gain or loss. This retirement will decrease the number of shares issued and the number of outstanding shares.

The entry to record the retirement above the original issuance price:

Share Capital	XX	
Share Premium	XX	
Cash		XX
Paid-in capital from retirement		XX

The entry to record the retirement below the original issuance price:

Share Capital	XX	
Share Premium	XX	
Paid-in capital from retirement*	XX	
Retained Earnings		
Cash		XX

*if there is an available balance

STOCK RIGHTS, SHARE WARRANTS, SHARE OPTIONS AND SHARE APPRECIATION RIGHTS

Share Rights

The Revised Corporation Code states that all stockholders of a stock corporation shall enjoy preemptive right to subscribe to all issues or disposition of shares of any class. Share rights are rights issued to the shareholders allowing them to purchase the new shares before it will be offered to other interested parties outside the corporation. At the date of issuance of rights, only memorandum entry will be prepared in the books of the corporation.

The entry to record the issuance of rights:
Memorandum entry: Issued (no. of stock rights) to shareholders permitting them to purchase (no. of shares) of (par value) at (selling price) for every (no. of rights) submitted.

The entry to record the exercise of the rights:

Cash	XX	
Share capital		XX
Share premium		XX

The entry to record the expiration of unused rights:
Memorandum entry: (no. of share rights expired) of the (total no. of share rights issued) issued to the shareholders expired.

Share Warrants

Corporation may issue debt (e.g., bonds) or equity (e.g., preference shares) securities with warrants attached. These share warrants enable the holder to purchase share of stocks from the company upon surrender of the warrants and pay certain amount.

When preference shares are issued with warrants, the amount received needs to be distributed between the preference shares and the warrants using the fair values of the securities at the date of issuance. The value attached to the warrants is credited to Ordinary Share Warrants Outstanding or any other appropriately described account which is reported in the statement of financial position as part of the share premium. If the warrants expire, the amount assigned to the share warrants will be transferred to another paid-in capital account (Robles and Empleo, 2019).

The entry to record the issuance of preference shares with warrants:

Cash	XX	
Preference Share Capital		XX
Preference Share Premium		XX
Ordinary Share Warrants Outstanding		XX

The entry to record the exercise of the warrants:

Cash (no. of equivalent shares x issue price)	XX	
Ordinary Share Warrants Outstanding	XX	
Ordinary Share Capital no. of equivalent shares x par value)		XX
Ordinary Share Premium		XX

The entry to record the expiration of the warrants:

Ordinary Share Warrants Outstanding	XX	
Share Premium form Expired Warrants		XX

Share-Based Payment

A share-based payment transaction is a transaction in which the entity receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement or incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.

An entity shall apply this IFRS 2 in accounting for all share-based payment transactions, whether or not the entity can identify specifically some or all of the goods or services received, including equity-settled share-based payment transactions, cash-settled share-based payment transactions, and transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments.

An entity shall recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognise a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share-based payment transaction. When the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, they shall be recognized as expenses.

Share-based payment transactions, in particular those with employees, are often conditional on the achievement of conditions. IFRS 2 distinguishes between vesting conditions and non-vesting conditions as follows:

1. **Vesting conditions.** These are conditions that determines whether the entity receives the services that entitle the counterparty to receive cash, other assets, or equity instruments of the entity, under a share-based payment arrangement. A vesting condition is either a service condition or a performance condition.

Service Condition	Performance Condition
This is a vesting condition that requires the counterparty to complete a specified period of service during which services are provided to the entity. If the counterparty, regardless of the reason, ceases to provide services during the vesting period, then it has failed to satisfy the condition.	This is a vesting condition that requires the counter party to complete a specified period of service and specified performance target(s) to be met while services are rendered. A performance target can be one of the following conditions: ❖ **Market performance condition.** If it is based on the price of the entity's equity instruments. Example: achieving a certain share price target. ❖ **Non-market performance condition.** If it is based on the entity's operations or activities. Example: achieving a certain profit target.

2. **Non-vesting conditions.** A condition other than a vesting condition that determines whether a counterparty receives the share-based payment. Example: Counterparty's choice of participation in share purchase program by paying monthly contributions.

Share Options or Equity-Settled Share-Based Payment

Share option is a contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period. Equity-settled share-based payment transactions with is measured on the date of grant. An estimate is made of the number of share options for which the service and non-market performance conditions are expected to be satisfied. The product of this estimate (fair value at the date of grant multiplied by the number of share options for which the service and non-market performance conditions are expected to be fulfilled) is the estimate of the total share-based payment cost. This cost is recognized over the vesting period, with a corresponding entry in equity. The cost is recognized as an expense or capitalized as an asset if the asset recognition criteria in IFRS are met. If the payment is not subject to a service condition, then it is recognized immediately.

After initial recognition and measurement, the estimate of the number of share options for which the service and non-market performance conditions are expected to be satisfied is revised during the vesting period. The cumulative amount recognized at each reporting date is based on the number of share options for which the service and non-market performance conditions are expected to be satisfied.

Share Appreciation Rights or Cash-Settled Share-Based Payment

Cash-settled share-based payment transaction is a share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the share price of the entity or another group entity. Typical example of cash-settled share-based payment is the share appreciation right.

Employee services received in a cash-settled share-based payment are measured at the fair value of the liability at grant date. Measurement of the liability considers the extent to which services have been rendered to date. The fair value at the date of grant of the liability is recognized over the vesting period. If no services are required, then the amount is recognized immediately. The fair value of the liability at the date of grant is capitalized if the services received qualify for asset recognition.

At end of each reporting period, and at the settlement date, the fair value of the recognized liability is remeasured. Remeasurement applies to the recognized portion of the liability through to vesting date. The full amount is remeasured from vesting date to settlement date. The cumulative net cost or compensation expense that will ultimately be recognized in respect of the transaction will be equal to the amount paid to settle the liability.

Remeasurements during the vesting period are recognized immediately to the extent that they relate to past services and recognition is spread over the remaining vesting period to the extent that they relate to future services. That is, in the period of the remeasurement there is a catch-up adjustment for prior periods for the recognized liability at each reporting date to equal a defined proportion of the total fair value of the liability. The recognized proportion is generally calculated by dividing the period for which services have been provided as at the reporting date by the total vesting period. Remeasurements are recognized in profit or loss. Moreover, any remeasurement after the vesting period are recognized immediately in profit or loss.

RETAINED EARNINGS

The retained earnings is a separate category in the shareholders' equity that represents the cumulative amount of profit or loss by the company since its incorporation, less the amount of dividends declared. It is sometimes subject to other types of accounting adjustments, such as changes in accounting policy and corrections of prior period errors.

In some cases, either as a management choice or as a legal requirement, certain portions of the retained earnings are appropriated. Appropriations of retained earnings are created to make

sure that dividends are not paid from these balances, and these appropriations need to be reported separately. When balance of the retained earnings account drops to negative (debit) balance, it is generally referred to as a deficit.

Dividends

Dividends are considered as distribution of earnings or capital to shareholders as declared by the board of directors. There are three important dates to be considered in dividend distribution, namely:

a. **Date of Declaration.** It is the date when the board of directors authorized the payment of dividends. The entry to record the declaration of dividends will include a reduction to the retained earnings.
b. **Date of Record.** It is the date when the list of shareholders who are entitled to the dividend is prepared. There is no formal journal entry on this date.
c. **Date of payment of distribution.** It is on this day that dividend payments are distributed to the shareholders of record.

There are various types of dividends, such as:

1. **Cash Dividends.** This is the most common type of dividend where the board of director declares cash to be received by the entitled shareholders. A declared cash dividend is a liability. A company may declare dividends either as a certain percentage of par, such as a 5% dividend on preference shares, or as an amount per share, such as P5 peso per ordinary share. In the first case, the rate multiplied by the par value of outstanding shares equals the total dividend. In the second, the dividend equals the amount per share multiplied by the number of shares outstanding. Take note that when there are two types of shares of the company (preference and ordinary shares), the preference share dividends need to be satisfied first before the ordinary shareholders.
2. **Property Dividends.** Sometimes, a corporation may choose to pay a dividend with non-cash assets. This could include shares of other companies held as investments, property, plant and equipment, inventory, or any other asset held. These types of transactions are unusual because the asset need to be equally divisible among all shareholders, the fair value of the asset needs to be determined, and the asset must be able to be physically distributed to the shareholders. There will be an added step that the asset must first be revalued to its fair value before the dividend is distributed. This will usually result in a gain or loss to be recorded, which is applicable as the asset is being disposed to settle a liability.
3. **Scrip Dividends.** Corporation, because of insufficient funds to justify cash dividends, may declare scrip dividend where the corporation may issue liability instrument, typically a promissory note, which requires the corporation to pay the amount of cash dividend at a specified future date. Since it is a liability instrument, an interest may accrue to it that will be additionally paid to the shareholders and to be charged as interest expense.
4. **Stock Dividends or Share Dividends or Bonus Issue.** Companies can distribute dividends using its share of stocks to shareholders without depleting its cash resources. A stock dividend does not affect the assets and the liabilities of the firm. Moreover, since each shareholder receives the same percentage increase in shares, shareholders' proportional interest in the firm remains the same.
    a. **Small stock dividend.** It is a term used when the number of shares declared as dividends represents less than 20% of the outstanding shares. In this case, the amount of the dividend charged to the Retained Earnings is equal to the fair value of the shares at the date of declaration.
    b. **Large stock dividend.** It is a term used when the number of shares declared as dividends represents 20% or more of the outstanding shares. In this case, the

amount of the dividend charged to the Retained Earnings is equal to the par value of the shares.

5. **Liquidating Dividends.** These are distributions to shareholders that originates from the amount that shareholders invested in the company rather than distribution of earnings. Thus, on the date of declaration, it should be charge to the share premium account rather than retained earnings.

Share Split

A share split or stock split increases the number of outstanding shares of the corporation. It causes a decrease of market price of individual shares. On the other hand, a reverse share split reduces the number of outstanding shares with a corresponding increase in the value of the share.

Share split and reverse share split are recorded using memorandum entry and it does not change the total shareholders' equity of the company.

BOOK VALUE PER SHARE

Book value per share is the amount each share would receive if the company will be liquidated based on amounts reported on the statement of financial position. This can be computed for both the ordinary and preference share.

If the company issues only one type of share (specifically ordinary shares), then the book value per share can be computed as follow:

$$\text{Book Value per Share} = \frac{\text{Total shareholders' equity}}{\text{Number of outstanding shares}}$$

However, if the company issues both preference and ordinary shares, the equity of preference shareholders should be determined first, then the excess of it from the total shareholders' equity will be attributable to the ordinary shareholders.

Total Shareholders' Equity		XX
Equity identified with Preference Shares		
Liquidation value of preference shares	XX	
Dividend in arrears (for the cumulative preference shares only)	XX	XX
Equity identified with Ordinary Shares		XX

$$\text{Book Value per Preference Share} = \frac{\text{Equity identified with preference shares}}{\text{Number of outstanding preference shares}}$$

$$\text{Book Value per Ordinary Share} = \frac{\text{Equity identified with ordinary shares}}{\text{Number of outstanding ordinary shares}}$$

QUASI-REORGANIZATION

Corporations may have debit balance in their retained earnings, known as deficit. This amount may be the result of accumulated losses over the years or other significant debits in the retained earnings. An entity in financial distress may be permitted by the Securities and Exchange Commission (SEC) to undertake a quasi-reorganization and in the process may be allowed to revalue its fixed assets (real properties, permanently installed fixed assets and machineries and equipment directly needed and used in the business).

Normally in a revalued quasi-reorganization, assets are to reflect their current market values. This may require write-down of some assets against Retained Earnings, thus

increasing the deficit. But appraisals of fixed assets will be recorded in the Revaluation Surplus which may be used to zero out the Retained Earnings.

On the other hand, recapitalization may take place. A recapitalization is a change in the capital structure by changing the par or stated value of the company's shares creating additional share premium. This share premium is then used to eliminate the deficit of the corporation.

ASSESSMENT ACTIVITIES

DISCUSSION QUESTIONS

In a separate sheet of paper, kindly copy the questions, then answer.

1. Identify and briefly describe the primary sources of shareholders' equity.
2. Identify the three common forms of business organization and the primary difference between the way they are accounted for.
3. Corporations offer the advantage of limited liability. Explain what is meant by that statement.
4. The owners of a corporation are its shareholders. If a corporation has only one class of shares, they typically are labeled common shares. Indicate the ownership rights held by common shareholders, unless specifically withheld by agreement.
5. What is meant by a shareholder's preemptive right?
6. Terminology varies in the way companies differentiate among share types. But many corporations designate shares as common or preferred. What are the two special rights usually given to preferred shareholders?
7. Most preferred shares are cumulative. Explain what this means.
8. The par value of shares historically indicated the real value of shares and all shares were issued at that price. The concept has changed with time. Describe the meaning of par value as it has evolved today.
9. The balance sheet reports the balances of shareholders' equity accounts. What additional information is provided by the statement of shareholders' equity?
10. At times, companies issue their shares for consideration other than cash. What is the measurement objective in those cases?
11. Companies occasionally sell more than one security for a single price. How is the issue price allocated among the separate securities?
12. The costs of legal, promotional, and accounting services necessary to effect the sale of shares is referred to as share issue costs. How are these costs recorded? Compare this approach to the way debt issue costs are recorded.
13. When a corporation acquires its own shares, those shares assume the same status as authorized but unissued shares, as if they never had been issued. Explain how this is reflected in the accounting records if the shares are formally retired.
14. Discuss the conceptual basis for accounting for a share buyback as treasury stock.
15. The prescribed accounting treatment for stock dividends implicitly assumes that shareholders are fooled by small stock dividends and benefit by the market value of their additional shares. Explain this statement. Is it logical?
16. Brandon Components declares a 2-for-1 stock split. What will be the effects of the split, and how should it be recorded?
17. What is a reverse stock split? What would be the effect of a reverse stock split on 1,000,000, P100 par shares? On the accounting records?
18. Suppose you own 80 shares of Facebook common stock when the company declares a 4% stock dividend. What will you receive as a result?
19. Describe the differences between share rights, share warrants, share options, and share appreciation rights.

20. A quasi reorganization is sometimes employed by a firm undergoing financial difficulties but with favorable future prospects. What are two objectives of this procedure? Briefly describe the procedural steps.

PROBLEMS

Show your complete solution, in good accounting form, on a separate sheet of paper.

Problem 1

Seo Dal Mi Co. was organized at the beginning of the current year. The following shareholders' equity accounts are included in the entity's year-end trial balance.

Preference share capital, P100 par, authorized 100,000 shares, issued and outstanding, 66,000 shares	P6,600,000
Preference share capital subscribed, 6,000 shares	600,000
Share premium – preference	240,000
Subscriptions receivable – preference	360,000
Ordinary share capital, P10 par value, authorized 200,000 shares, issued and outstanding, 72,000 shares	720,000
Ordinary share capital subscribed, 72,000 shares	720,000
Share premium – ordinary	2,850,000
Subscriptions receivable – ordinary	1,080,000

The following current year transactions relate to Seo Dal Mi Co.'s shareholders' equity:

- Immediately after Seo Dal Mi Co. was organized, it received subscriptions to 60,000 preference shares. Subscriptions to ordinary shares were also received on the same date.
- During the year, subscriptions were received for an additional 12,000 preference shares at a price of P120 per share.
- Cash payments were received from subscribers at frequent intervals for several months after subscription. The company's policy is to issue share certificates only upon full payment of the share subscription.
- Also, during the current year, Seo Dal Mi Co. issued 24,000 ordinary shares in exchange for a tract of land with a fair value of P690,000.

What is the total subscription price of the ordinary shares originally subscribed?
How much was collected from the subscribers of preference shares?
How much should be reported as report contributed capital in the company's statement of financial position at the end of the current year?

Problem 2

The following shareholders' equity accounts are included in the statement of financial position of Nam Do San Co. on December 31, 2020.

Preference share capital, 8%, P100 par (200,000 shares authorized, 60,000 shares issued and outstanding)	P6,000,000
Ordinary share capital, P5 par (2,000,000 shares authorized, 600,000 shares issued and outstanding)	3,000,000
Share premium	3,750,000
Retained earnings	3,500,000
Total	P16,250,000

During 2021, Nam Do San took part in the following transactions concerning equity.

1. Paid the annual 2020 P8 per share dividend on preference shares and a P2 per share dividend on ordinary shares. These dividends had been declared on December 31, 2020.
2. Purchased 81,000 shares of its own outstanding ordinary shares for P40 per share.
3. Reissued 21,000 treasury shares for land valued at P900,000.
4. Issued 15,000 preference shares at P105 per share.
5. Declared a 10% stock dividend on the outstanding ordinary shares when the shares are selling for P45 per share.
6. Issued the stock dividend.
7. Declared the annual 2021 P8 per share dividend on preference shares and the P2 per share dividend on ordinary shares. These dividends are payable in 2022.
8. Reported net income of P9,900,000 for the current year.

What is the retained earnings balance (before appropriation for treasury shares) on December 31, 2021?
What amount should be reported as total shareholders' equity on December 31, 2021?

Problem 3
At the beginning of 2019, Han Ji Pyung Corp. grants to a senior executive 30,000 share options. The grant is conditional upon the executive remaining in the entity's employ until the end of 2021.

The share options can be exercised if the entity's share price increases from P20 at the beginning of 2019 to above P30 at the end of 2021. If the share price is above P30 at the end of 2021, the share options can be exercised at any time during the next five years, i.e., by the end of 2026.

The entity estimates the fair value of the share options on grant date to be P5 per option. This estimate takes into account the following market condition:

- The possibility that the share price will exceed P30 at the end of 2021, i.e., the share options become exercisable; and
- The possibility that the share price will not exceed P30 at the end of 2021, i.e., the share options will be forfeited.

The following actual events occurred in years 2019 to 2021:
2019
- The share price has increased to P24.
- The entity's estimate of the fair value of the options is P4 at the end of 2019. This takes into account whether the market condition will be satisfied by the end of 2021.

2020
- The share price has decreased to P22. However, the entity remains optimistic that the share price target will be met by the end of 2021.
- The estimated fair value of the share options is P3. Again, this estimate takes into account the market condition noted above.

2021
- The share price only reaches P28 by the end of 2021.
- The estimated fair value of the share options is zero, as the market condition has not been satisfied.

How much is the compensation expense for 2019, 2020 and 2021?

How much is the share options outstanding at the end of 2020?
How much is the cumulative compensation expense for the three-year period?
Prepare all the entries from 2019 to 2021.

Problem 4

On January 1, 2019, Won In Jae Company granted to an employee the right to choose either shares or cash payment. The choices are as follows:

- Share alternative – equal to 25,000 shares with par value of P30
- Cash alternative – cash payment equal to the market value of 20,000 shares

The grant is conditional upon the completion of three years of service. On grant date, on January 1, 2019, the share price is P51. The share prices for the three-year vesting period are P54 on December 31, 2019, P66 on December 31, 2020, and P65 on December 31, 2021. After taking into account the effect of vesting restrictions, the entity has estimated that the fair value of the share alternative is P48.

What is the compensation expense for 2019, 2020 and 2021?
What is the share premium if the employee has chosen the share alternative on December 31, 2021?
What is the share premium if the employee has chosen the cash alternative on December 31, 2021?
Prepare all the entries from 2019 to 2021.

Problem 5

Answer the following independent questions.

a. On May 31, year 1, Ball Corporation's board of directors declared a 10% stock dividend. The market price of Ball's 30,000 outstanding shares of P20 par value common stock was P80 per share on that date. The stock dividend was distributed on July 31, year 1, when the stock's market price was P100 per share. **What amount should Ball credit to share premium for this stock dividend?**

b. On November 30 Year 1, a company declared property dividends when the property has a carrying amount of P500,000 and fair value of P520,000. On December 31, Year 1, the fair value less cost to distribute of the property is P480,000. On February 25, the date of payment, the property has fair value less cost to distribute of P470,000. **The gain or loss on distribution of the property dividend is**

c. On March 30, year 1, Mitz Co. declared a 30% ordinary share dividend. Shares were selling on the market on this date at P25 per share. The par value is P10 per share and 180,000 shares are outstanding. In distributing the stock dividend, Mitz Co. issued fractional share warrants totaling 600 shares. Assuming that 60% of the warrants are exercised and the remaining warrants expire, **the entry to record the exercise and expiration of the fractional share warrants is**

d. Rod Corp. had 700,000 ordinary shares authorized and 300,000 shares outstanding on January 1, Year 1. The transaction for Year 1 follows:

Jan 01	Declared and distributed 10% stock dividends
Jun 30	Acquired 100,000 shares
Aug 01	Issued 50,000 shares
Nov 30	Declared 2-for-1 share split

How many are the ordinary shares outstanding?

e. Beauty Company has the following information:

Preference share capital P500 par	1,100,000
Ordinary share capital, P100 par	600,000
Treasury shares (ordinary), P100 cost	110,000
Retained earnings	2,500,000

Subsequently, the company declared, 100% stock dividend on both classes of shares. Also, the company declared 10% cash dividend on preference shareholders and P10 cash dividend per ordinary share. **What is the shareholders' equity after considering the dividends?**

f. Retained earnings beginning balance is P750,000. Other information are as follows: current year net income of P230,000, dividends of P400,000, other comprehensive income of P70,000 and prior period adjustment for overstatement of cost of sales amounting to P20,000. **How much is Retained earnings ending balance?**

g. At the beginning of the current year, the company reported P1,750,000 of appropriated retained earnings for the construction of the new building which was completed late in the current year. For the current year, P1,200,000 was appropriated for plant expansion. P1,500,000 cash was restricted for the retirement of bonds payable. Also, the company acquired treasury shares for a total cost of P500,000. **On December 31 of the current year, the entity should report appropriated retained earnings of**

h. During the first three years of operation, the company had net income of P800,000, P2,500,000 and P3,000,000, respectively. The entity also declared and paid dividends totaling P2,000,000 for the last three years. For the current year, Year 4, the company reported the following

Net income before tax	4,800,000
Prior period adjustment-understatement of depreciation (before tax)	400,000
Cumulative decrease in income from change in inventory method (before tax)	700,000
Dividends declared	2,000,000
Income tax rate	30%

What is the retained earnings as of December 31, Year 4?

g. The company has P7,000,000 ordinary share capital, P1,600,000 share premium and P900,000 deficit in retained earnings. Recapitalization was effected as follows:

- Inventory recorded at P6,500,000 has market value of P6,400,000 at year-end.
- Property, plant, and equipment with carrying amount of P12,000,000 has P8,000,000 sound value.
- Par value of share is reduced from P10 to 5.

What should be the Shareholder's equity after quasi-reorganization?

GRADING SYSTEM

Class Standing		
Quizzes	50%	
Assignments	20%	70%
Departmental Exam		30%
Total		100%

$$\text{Final Grade} = \frac{\text{Midterm Grade + Final Term Grade}}{2}$$

REFERENCES/ READING MATERIALS

• Robles, Nenita S. and Empleo, Patricia M. (2019). The Intermediate Accounting Series, Volume 3, Millennium Books Inc.

• CIRC HF 5635 W37 2014, Warren, Carl S., Financial Accounting, 13th ed., 2014

• CIRC HF 5635 F56 2013, William, Jan R., Financial & Managerial Accounting: The basis for business decisions, 16th ed., 2013

• CIRC HF 5635 F5313 2013, William, Jan R., Financial Accounting, 15th 3d. 2013

• REF HF 5626 1594 W55 2013, Wiley 2012 Interpretation and application of international financial reporting standards, Bruce Mackenzie, 2013

• Baysa, Gloria T. and Lupisan, Ma. Concepcion Y. (2014). Accounting for Partnership and Corporation. Millennium Books Inc.

• IAS 1: *Presentation of Financial Statements*, https://www.ifrs.org/issued-standards/list-of-standards/ias-1-presentation-of-financial-statements/

• IAS 12: *Income Taxes*, https://www.ifrs.org/issued-standards/list-of-standards/ias-12-income-taxes/

• IAS 19: *Employee Benefits*, https://www.ifrs.org/supporting-implementation/supporting-materials-by-ifrs-standard/ias-19/

• IAS 37: *Provisions, Contingent Liabilities and Contingent Assets*, https://www.ifrs.org/issued-standards/list-of-standards/ias-37-provisions-contingent-liabilities-and-contingent-assets/

• IFRS 2: *Share-based Payment*, https://www.ifrs.org/supporting-implementation/supporting-materials-by-ifrs-standard/ifrs-2/

• IFRS 15: *Revenue from Contracts with Customers*, https://www.ifrs.org/issued-standards/list-of-standards/ifrs-15-revenue-from-contracts-with-customers/

• IFRS 16: *Leases*, https://www.ifrs.org/issued-standards/list-of-standards/ifrs-16-leases/

• Republic Act 11232: Revised Corporation Code of the Philippines